Catholic University Law Review

Volume 56
Issue 1 *Fall 2006*

Article 5

2006

"Clowns to the Left of Me: Jokers to the Right, Here I Am, Stuck in the Middle with You": The Inconsistent Tax Treatment of Security Holders in Tax-Free Reorganizations

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"CLOWNS TO THE LEFT OF ME, JOKERS TO THE RIGHT, HERE I AM, STUCK IN THE MIDDLE WITH YOU"[1]: THE INCONSISTENT TAX TREATMENT OF SECURITY HOLDERS IN TAX-FREE REORGANIZATIONS

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1. STEALERS WHEEL, *Stuck in the Middle with You*, *on* Stealers Wheel (Lemon Records 1972).

I. INTRODUCTION

The tax treatment of holders of security instruments in tax-free reorganizations is inconsistent with public policy regarding the promotion of long-term investments. Congress has repeatedly demonstrated a commitment to encouraging long-term investment.[2] The reorganization provisions penalize holders of long-term investments and encourage investing in short-term instruments instead. The tax treatment of security instruments contravenes the underlying policy justifications for the reorganization provisions, including encouraging long-term investment in corporate enterprises.[3] While public policy dictates that long-term investment in corporations is better than short-term investment, ultimately, holders of debt instruments are in a more favorable tax position if their investment is determined to be a short-term, non-security debt instrument rather than a long-term security instrument.[4]

The Internal Revenue Code (the Code) provides that a taxpayer will not recognize gain or loss if the taxpayer exchanges stock or securities in one corporation for stock or securities in another corporation, as long as the exchange is pursuant to a tax-free reorganization.[5] The term "tax-free reorganization" leads taxpayers to believe that if a taxpayer exchanges stock or securities for different stock or securities in a new corporation in connection with a tax-free reorganization, the taxpayer will receive the new stock or securities tax free, without recognizing any gain or loss.

A taxpayer's assumption that the transaction is tax free would be correct in most cases with regard to *stock* in a corporation if the exchange

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2. *See, e.g.*, I.R.C. §§ 1(h), 1222 (2006) (providing for reduced capital gain rates for property held for over one year and reduced dividend rates to encourage corporate investment).

3. *See, e.g.*, §§ 1(h), 1222.

4. A debt instrument is defined as "any instrument or contractual arrangement that constitutes indebtedness under general principles of Federal income tax law." *See* Treas. Reg. § 1.1275-1(d) (as amended in 2002).

5. *See* I.R.C. § 354(a); *see also* § 368 (outlining the requirements for qualifying as a tax-free reorganization).

meets the other requirements of a tax-free reorganization.[6] If, however, a taxpayer holds a *security instrument* instead of stock, the taxpayer's assumption that the exchange is tax free will probably not be correct. Although the assumption that the exchange of security instruments is tax free would be logical based on the implication from the initial wording of the statute, to say that an exchange of security instruments in a tax-free reorganization is tax free is only telling half of the story.[7]

In an exchange of security instruments pursuant to a tax-free reorganization, the tax treatment ends up being the worst scenario for the taxpayer. The taxpayer will receive tax-free treatment when the taxpayer would actually prefer taxable treatment, and the taxpayer will receive taxable treatment when the taxpayer would actually prefer tax-free treatment.[8] An exchange of security instruments is tax free under the reorganization provisions to the extent the taxpayer has a loss, and as a result, a taxpayer cannot take a loss on an exchange of security instruments in a tax-free reorganization.[9] But, an exchange of security instruments in a tax-free reorganization is fully taxable to the extent the taxpayer has any gain.[10] For most taxpayers, being prevented from recognizing losses and being required to recognize gain is the most unfavorable tax treatment possible.[11] Alternatively, a taxpayer who exchanges stock in a tax-free reorganization does not have to recognize any gain and is also prevented from recognizing any loss on the exchange.[12]

The conflicting tax treatment between stock and security instruments can be justified on the basis that a security instrument is a type of debt instrument, as opposed to stock, which is an equity interest; therefore, security instruments are not entitled to the same tax treatment as stock. As discussed below, however, there is not a sufficient justification for the conflicting tax treatment between security instruments and other types of debt instruments that do not qualify as security instruments. The tax

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6. *See* § 354(a); *see also* §§ 356, 368. This discussion assumes that the debt-for-debt exchanges are in connection with either a merger, reorganization, or financial restructuring as the result of business motivations and not as a result of financial distress or insolvency. There are specific reorganization provisions, specifically G reorganizations in section 368(a)(1)(G), that deal with bankrupt or insolvent corporations. *See* § 368(a)(1)(G). The treatment of security instruments in these reorganizations, however, is beyond the scope of this Article.

7. *See infra* notes 9-12 and accompanying text.

8. *See* §§ 165(a), 166, 354(a), 356(c), (d)(2)(B).

9. *See* §§ 354(a), 356(c).

10. *See* §§ 354(a)(2), 356(d)(2)(B).

11. There are, of course, unique tax positions for many taxpayers where triggering gain immediately and deferring a loss might be the most advantageous tax treatment because of their particular circumstances.

12. *See* § 354.

treatment of security instruments becomes inconsistent when comparing different types of debt exchanges in tax-free reorganizations.

Non-security debt instruments receive better tax treatment from the tax-free reorganization provisions than security instruments.[13] Security instruments are included in the tax-free reorganization provisions because they represent long-term, continuing interests in a corporation as opposed to non-security debt instruments, which do not represent a true continuing interest in the corporation.[14] Non-security debt holders are not entitled to tax-free treatment under the reorganization provisions because non-security debt instruments merely represent short-term notes that are not intended for long-term investment and are more like a creditor-type interest.[15] This explanation for the different tax treatment between the two types of instruments would be perfectly reasonable if the tax treatment afforded to holders of security instruments truly was tax free. However, because holders of security instruments are taxed on a part of their gain, the characterization of security instruments as long-term investments entitled them to be included in the tax-free reorganization provisions, which conflicts with actual tax treatment of security instruments.

The tax treatment afforded to security instruments and non-security debt instruments illustrates that the tax treatment is unequal and inconsistent. The tax consequences of an exchange of non-security debt instruments in a tax-free reorganization are much more favorable than the tax consequences of holders of security instruments. Because non-security debt instruments are not included in the tax-free reorganization provisions, an exchange of non-security debt instruments is a fully taxable event.[16] In a tax-free reorganization, holders of non-security debt instruments are able to recognize any losses realized on an exchange of debt

13. A non-security debt instrument is essentially any debt instrument that is not classified as a security instrument for tax purposes. Determining what is classified as a security instrument is not, however, an easy evaluation and is addressed in greater detail in Part III.A of this Article.

14. *See* Pinellas Ice & Cold Storage Co. v. Comm'r, 287 U.S. 462, 468-69 (1933); Camp Wolters Enters., Inc. v. Comm'r, 230 F.2d 555, 559-60 (5th Cir. 1956); Burnham v. Comm'r, 86 F.2d 776, 777 (7th Cir. 1936); Cortland Specialty Co. v. Comm'r, 60 F.2d 937, 940 (2d Cir. 1932).

15. *See* I.R.C. §§ 354(a)(1), 356(a)(1); *see also Pinellas*, 287 U.S. at 468-69; *Camp Wolters*, 230 F.2d at 559-60; *Burnham*, 86 F.2d at 777; *Cortland*, 60 F.2d at 940. *See generally* Neville Coke & Chem. Co. v. Comm'r, 148 F.2d 599, 602 (3d Cir. 1945) (asking whether "the notes . . . give [the taxpayer] a 'proprietary' interest in the enterprise or [whether it was] only a creditor" when determining if the notes were security instruments or not).

16. *See* I.R.C. § 1001(a); Treas. Reg. §§ 1.1001-1 (as amended in 1996), 1.1001-3 (as amended in 1996).

instruments and are also required to recognize any gain.[17] This puts holders of non-security debt instruments in a more advantageous tax position than holders of security instruments. Both security holders and non-security holders have to recognize any gain on an exchange in a tax-free reorganization, but only holders of non-security debt instruments are allowed to recognize losses.[18]

The difference between the tax treatment of holders of security instruments and the tax treatment of holders of non-security instruments is incompatible with good public policy. Providing more favorable tax consequences to holders of non-security debt instruments in a tax-free reorganization may discourage long-term investments in corporations and instead encourage investing in shorter-term instruments.

The reorganization provisions in sections 354 and 368 of the Code provide that an exchange of stock or security instruments for new stock or security instruments will be tax free if the other requirements of the statute are met.[19] The reorganization provisions in the Code benefit holders of stock and penalize holders of long-term security instruments, while allowing holders of non-security debt instruments fully taxable treatment.[20] Congress originally enacted the tax-free reorganization provisions to avoid taxing profits that were purely on paper and to avoid interfering with normal business adjustments.[21] Presumably, stock and security instruments were included in the reorganization provisions, while other types of debt instruments were excluded because non-security debt instruments were more akin to cash.[22] Therefore, they should not be af-

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17. *See* I.R.C. §§ 165(a), 166, 354(a), 356(a)(1), 1001(a). Section 354 would not apply to an exchange of a non-security instrument for a non-security instrument and therefore, the basic sale or exchange rules under section 1001 would apply. This assumes that no other types of stock or security instruments of the debt holder were exchanged. If stock or securities are also exchanged in connection with the non-security instruments, then losses on any of the property held become precluded under section 356(c). *See* §§ 356(a)(1), (c), 1001(a).

18. *See* §§ 165(a), 166, 356(c). Assume, for example, that a taxpayer owns a security instrument with an adjusted basis of $50 in Dell, Inc. Dell, Inc. and IBM decide to merge and pursuant to a tax-free reorganization, the taxpayer receives a security instrument in IBM worth $30 in exchange for his Dell, Inc. security instrument. The taxpayer has a $20 loss on the exchange of his security instruments. However, because he is exchanging security instruments pursuant to a tax-free reorganization, he cannot recognize the loss. *See* § 354(a). If, however, the taxpayer owned a $50 non-security debt instrument in Dell, Inc. instead of a security instrument, then he would be able to recognize a loss on the exchange. *See* § 166.

19. *See* §§ 354(a)(1), 368.

20. *See* §§ 354(a)(1)-(2), 356(a), (c), 1001(c).

21. *See* H.R. REP. NO. 73-704, at 9-10 (1934); S. REP. NO. 65-617, at 5-6 (1918).

22. *See* Pinellas Ice & Cold Storage Co. v. Comm'r, 287 U.S. 462, 468-69 (1933); Camp Wolters Enters., Inc. v. Comm'r, 230 F.2d 555, 559-60 (5th Cir. 1956); Neville Coke & Chem. Co. v. Comm'r, 148 F.2d 599, 602 (3d Cir. 1945); Burnham v. Comm'r, 86 F.2d 776, 777 (7th Cir. 1936); Cortland Specialty Co. v. Comm'r, 60 F.2d 937, 940 (2d Cir. 1932).

forded the same tax-free benefit that stock and security instruments are afforded.

It appears that it was an attempt on the part of Congress to provide equity-type interests with tax-free treatment in an exchange and to provide that an exchange of debt would be fully taxable.[23] As will be discussed in greater detail later, this attempt to draw such a line between debt and equity with security instruments failed because security instruments are a type of debt, and trying to impose equity-like characteristics on these instruments resulted in tax consequences that did not represent the true economics of the transaction.[24]

The irony is that, although the definition of a security instrument is unclear, there is one overriding principle in the various interpretations of a security instrument: a security instrument is a long-term debt instrument that represents a continuing interest in the growth of the reorganizing business, whereas a non-security debt instrument represents an investment that has little or no continuing interest in the corporation.[25] This type of long-term investment in a corporation is really a misnomer. In reality, both non-security debt instruments and security instruments are generally freely tradable; rarely does the motive of the investor ever actually represent an intention to invest with the corporation for a long term.

Part II of this Article will provide a hypothetical that illustrates the inconsistent tax treatment of security holders in a tax-free reorganization as compared to holders of stock and holders of non-security debt instruments. Following the hypothetical, Part III of this Article will discuss the tax consequences of an exchange of security instruments and non-security instruments in a tax-free reorganization, the policy reasons or justifications behind the reorganization provisions, and the possible justifications for the disparate treatment of security holders. This discussion will include an examination of whether or not an interest that a taxpayer holds is a security instrument, what the tax consequences are of the underlying exchange to the holders of security instruments, and the tax consequences to the corporation of the tax-free exchange. Once the tax consequences of an exchange of security instruments in a tax-free reorganization have been evaluated, Part IV of this Article will then discuss the tax

23. *See* S. REP. NO. 65-617, at 5-6; *see also Pinellas*, 287 U.S. at 468-69.

24. The same type of confusion in drawing a line between debt and equity results from non-qualified preferred stock, which is treated as equity with debt-like characteristics. While it is beyond the scope of this Article, it is this author's position that non-qualified preferred stock also provides for inconsistent and unequal tax consequences, and rather than focusing on line drawing, the tax implications should depend on the actual economics of the exchange.

25. *See Camp Wolters*, 230 F.2d at 559-60; *Burnham*, 86 F.2d at 776-77; Rev. Rul. 2004-78, 2004-31 I.R.B. 108, 108-09.

consequences of a fully taxable exchange. Then, Part V of this Article will examine the policy justifications and the legislative history behind these provisions as well as current public policy and will suggest solutions that are consistent with current public policy motivations. Finally, Part VI of this Article will raise and then refute arguments in favor of retaining the current tax provisions regarding security instruments.

The tax treatment of security instruments in tax-free reorganizations is puzzling and inconsistent. A security instrument has been defined as a long-term debt instrument, an interest that represents a continuing ownership interest in the corporation. Non-security debt instruments generally represent a mere creditor's interest.[26] Yet, when compared to the tax consequences of an exchange of non-security debt instruments in a corporation in connection with a tax-free reorganization an exchange of security instruments has less favorable tax consequences.[27]

II. HYPOTHETICAL

The following hypothetical is designed to illustrate the inconsistent and contradictory tax treatment afforded to holders of security instruments when compared to holders of stock or non-security debt instruments.

Assume, for example, that George owns stock in Vandalay Industries, Inc. with an adjusted basis of $100 and a fair market value of $120, and that Jerry owns a security instrument with a twenty-year term in Vandalay Industries, Inc. with a principal amount and an adjusted basis of $100 and a fair market value equal to $120.[28] Vandalay Industries, Inc. merges into Pendant Publishing, Inc. in a tax-free reorganization under section 368. Pursuant to the reorganization, George exchanges his stock in Vandalay Industries, Inc. for new stock in Pendant Publishing, Inc. worth $120. Because the merger qualifies as a tax-free reorganization, George recognizes no taxable gain on the exchange of his stock.[29]

Jerry, pursuant to the reorganization, also exchanges his security instrument in Vandalay Industries, Inc. for a new security instrument in

26. *See Pinellas*, 287 U.S. at 468-69; *Camp Wolters*, 230 F.2d at 559-60; *Neville*, 148 F.2d at 602; *Burnham*, 86 F.2d at 777; *Cortland*, 60 F.2d at 940.

27. *See* I.R.C. §§ 354(a), 356(d)(2), 1001(a) (2006).

28. A taxpayer's adjusted basis is generally the amount of capital he has invested in property, which he will receive back on a sale or exchange free of gain. *See* §§ 1012, 1016(a)(1). In general, it represents the taxpayer's investment in the property and is the measuring point for determining gain or loss. In this hypothetical, the taxpayer's adjusted basis is equal to what the taxpayer paid for the property.

The fair market value of a debt instrument can depend on several factors, including the financial stability and credit worthiness of the corporation, the interest rate on the debt instrument, and the current market interest rate being offered on debt instruments. *See, e.g.*, Stephen B. Land, *Defeating Deferral: A Proposal for Retrospective Taxation*, 52 TAX L. REV. 45, 62 (1996).

29. *See* I.R.C. §§ 354(a)(1), 368(a)(1).

Pendant Publishing, Inc. with a principal amount and fair market value of \$120.[30] Even though the fair market value of what Jerry is giving up in the exchange is equal to the fair market value of what he is receiving, Jerry must recognize \$20 of gain because he holds a security instrument and not stock.[31]

At this point, the disparate treatment between the taxation of the exchange of George's stock versus Jerry's security instrument can be justified and rationalized because of the difference between an equity interest and a debt interest. The different tax treatment between Jerry's security interest and George's security interest is warranted once we must draw the line between debt and equity—with stock on the equity side and the security instrument on the debt side. Alternatively, we will see that to justify the differences between security instruments and non-security debt instruments, the line between debt and equity is drawn with non-security instruments on the debt side of the line and security instruments on either the equity side or the debt side of the line. This is the inconsistency.

Often, it appears inconsistent to security holders that the corporation in which they hold a long-term investment enters into a tax-free reorganization that generates only taxable gain and no recognizable loss to the security holder. Yet, at the end of the day, these holders still hold a security instrument in the corporation just as they had before. The security holders are taxed in spite of the fact that they have not cashed out their investment.

When the security instruments are exchanged for new security instruments, as in the above example, Jerry's ownership interest in the corporation has changed. He now owns a security instrument with different rights and risks. The change in his ownership interest justifies taxing the exchange and treating the exchange as a taxable event. This is also consistent with the tax treatment of an exchange of non-security debt instruments. The taxable treatment of an exchange of security instruments based on the different rights and risks involved is not, however, consistent with the tax-free treatment of stock in a tax-free reorganization. This is because, often, stock received in such an exchange will have different rights and risks, and yet the exchange will still be tax free. For example, if a new corporation issues security instruments or stock, both the security holder and the stockholder now hold an investment in a cor-

30. The principal amount in this example is \$120 for purposes of illustration. This might happen if, for example, the security instrument Jerry gave up in the exchange had a very high interest rate and a term that was coming due in the near future, and he received a security instrument with a lower interest rate and an extended term.

31. *See* §§ 354(a)(2), 356(d)(2)(B). The gain is actually based on the fair market value of the excess of the new principal amount over the original principal amount. For purposes of this hypothetical, and to keep it simple, assume the fair market value of this excess principal amount is equal to \$20.

poration with a different financial picture than the initial corporation in which they invested. Perhaps the interest rate or the dividend amount has changed as well. However, even though both stock and security instruments are included in the tax-free reorganization provisions, security holders are taxed on the exchange and only the stockholders receive gain tax free.[32]

This is not to say that taxing security holders on an exchange of security instruments is inappropriate. Rather, this example is meant to illustrate that inclusion of security instruments in the tax-free reorganization provisions appears to be inappropriate.

The inconsistent tax treatment of a holder of security instruments is further illustrated by comparing Jerry's tax treatment to the tax treatment of a holder of a non-security debt instrument in a loss scenario. Assume, for example, that Jerry holds a twenty-year security instrument in Vandalay Industries, Inc. with a principal amount and adjusted basis of \$100 and a fair market value of \$80. Assume further that Elaine owns a non-security debt instrument with a term of six months in Vandalay Industries, Inc. with a principal amount and adjusted basis of \$100 and a fair market value of \$80.[33] Vandalay Industries, Inc. merges into Pendant Publishing, Inc. in a merger that qualifies as a tax-free reorganization. Jerry receives a twenty-year security instrument in Pendant Publishing, Inc. with a principal amount and a fair market value of \$80. He has a \$20 loss but is prevented from recognizing the loss because the exchange qualifies as a tax-free reorganization.[34] Elaine exchanges her six-month debt instrument in Vandalay Industries, Inc. for a debt instrument with a six-month term in Pendant Publishing, Inc. with a principal amount and a fair market value of \$80.[35] Elaine recognizes her \$20 loss because she does not hold a security instrument and therefore is not subject to the tax-free reorganization provisions.[36]

Thus, Jerry, who holds a long-term interest in Vandalay Industries, Inc., which meets the criteria to be classified as a "security instrument," must recognize any potential gain on the exchange, but cannot recognize

32. *See supra* note 15 and accompanying text.

33. As will be discussed in greater detail in Part III.C of this Article, Elaine's gain or loss would actually be based on the issue price of her debt instrument rather than the debt's principal amount. *See* Treas. Reg. § 1.1001-1(g)(1) (as amended in 1996). To simplify the hypothetical, it is assumed for purposes of this example that Elaine's principal amount and issue price both equal \$100.

34. *See* I.R.C. § 356(c).

35. Again, for simplification purposes, it is assumed that the issue price of the debt instrument that Elaine receives is also equal to \$80. *See* Treas. Reg. § 1.1001-1(g)(1).

36. *See supra* note 16 and accompanying text. Note, however, that if Elaine held, in addition to her non-security debt instrument, any stock or additional security instruments in Vandalay Industries, Inc. that were also exchanged in the reorganization, she would be prevented from recognizing the loss as well. *See* I.R.C. § 356(c).

any potential loss in a tax-free reorganization.[37] Alternatively, if Jerry held a short-term debt instrument that did not qualify as a security instrument, he would have to recognize gain but would also be able to recognize any loss.[38]

There appears to be no justification for the inconsistent and inequitable treatment to holders of security instruments versus holders of other investments in corporations. The House of Representatives stated that it was concerned that security holders might take advantage of the reorganization provisions;[39] however, there is no explanation for why Congress chose to allow non-security holders fully taxable treatment that often results in more favorable tax treatment. Congress enacted the reorganization provisions over eighty years ago based on the policy motivations relevant at that time.[40] It is unclear whether these provisions are consistent with current public policy and economic conditions.

III. THE TAX TREATMENT OF EXCHANGES OF SECURITIES IN TAX-FREE REORGANIZATIONS

A. *Definition of Securities*

The first determination that a taxpayer holding a debt instrument must make in order to establish his tax treatment in a tax-free exchange is whether the taxpayer owns a security instrument or a non-security debt instrument. The term "security instrument" has been debated by courts for over seventy years and still has never been clearly defined.[41] Some of the possible ownership interests that a taxpayer may hold in a corporation include stock, a security instrument, or a non-security debt instrument. Many labels and titles given to ownership interests in a corporation do not necessarily correspond to the underlying nature of the interest. Often, the label given to an ownership interest is an attempt to sim-

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37. *See* § 356(a)(1)-(2), (c), (d)(2).

38. *See* §§ 61(a), 165(a), 166, 1001(a).

39. *See* H.R. REP. NO. 73-704, at 8-9 (1934); H.R. REP. NO. 67-350, at 11-12 (1921).

40. *See* S. REP. NO. 65-617, at 5 (1918).

41. *See* Helvering v. Watts, 296 U.S. 387, 389 (1935); Comm'r v. Neustadt's Trust, 131 F.2d 528, 529 (2d Cir. 1942) (stating that the term "securities" should be given its ordinary, plain meaning); Lagerquist v. Comm'r, 53 T.C.M. (CCH) 530, 534-35 (1987) (stating that the key factor is the amount of risk a debt holder takes). The definition of a security is used throughout the Code; however, the definitions differ depending on the code section. *See, e.g.*, I.R.C. §§ 165(g)(2), 166. The definition of security instruments under section 351 has been applied to define security instruments under sections 354 and 368. *See* Rev. Rul. 59-98, 1959-1 C.B. 76, 76-77. Under section 165(g)(2), debt securities may be of any term but must be issued by a corporation or a government and must either be in registered form or have interest coupons. *See* I.R.C. § 165(g)(2).

ply generate the desired tax consequences.[42] It would be a simple answer if the label given to an interest in a corporation could be trusted to reflect the true economic ownership interest in the corporation. However, as reflected by years of case law, taxpayers must look to the underlying property, the economic interests, and the attributes of the property to determine if an interest in a corporation is equity (such as stock) or debt.[43] Even when a taxpayer can confidently say that he owns a debt instrument rather than an equity interest in a corporation, the issue is further complicated by the confusion surrounding whether that debt instrument is a security instrument or a non-security debt instrument.

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42. The Internal Revenue Service (IRS) will not respect a label given if the underlying transaction does not correspond to the label. Rather, the IRS will recharacterize the transaction to fit with its appropriate label. This is known as the "substance over form doctrine." *See, e.g.*, Joseph Isenberg, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859, 879 (1982); Lewis R. Steinberg, *Form, Substance and Directionality in Subchapter C*, 52 TAX LAW. 457, 457 (1999).

43. One could write several articles alone on the classification of debt versus equity. *See generally* BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 4.02 (6th ed. 2000); Anthony P. Polito, *Useful Fictions: Debt and Equity Classification in Corporate Tax Law*, 30 ARIZ. ST. L.J. 761 (1998). Because it is an undertaking beyond the scope of this Article, it will not be addressed here.

Nonqualified preferred stock is an interesting example of another type of ownership interest that falls between debt and equity. Nonqualified preferred stock is often referred to as "debt-like preferred stock" because its attributes are so similar to debt. *See* Symposium, *The Future of Tax Law in the Face of Globalization: Practical and Policy Considerations*, 13 ST. JOHN'S J. LEGAL COMMENT. 35, 67 (1998). A right to acquire nonqualified preferred stock received in exchange for stock, other than nonqualified preferred stock, will not be treated as a security instrument. *See* I.R.C. § 351(g)(1). If, however, nonqualified preferred stock is exchanged for nonqualified preferred stock (or rights to nonqualified preferred stock for rights to nonqualified preferred stock) the exchange will qualify for tax-free treatment under section 354. The Treasury Regulations under section 356 provide that as long as the nonqualified preferred stock received in the exchange is "substantially identical" to the nonqualified preferred stock given up, the resulting exchange is tax free. *See* Treas. Reg. § 1.356-7(b)(1) (as amended in 2000). Nonqualified preferred stock is considered substantially identical to new nonqualified preferred stock if its terms are similar to the terms of the original nonqualified preferred stock and the potential of exercising the right or obligation attached to the stock "does not become more likely than not to occur within a 20-year period" by reason of the exchange (as of the date of the original issuance of the stock). § 1.356-7(b)(2). The new nonqualified preferred stock cannot "decrease the period in which a right or obligation . . . can be exercised, or increase the likelihood that such a right or obligation will be exercised, or accelerate the timing of the returns from the stock instrument, including . . . dividends or other distributions." *Id.* In addition to coming up with a bright line test for determining whether a debt instrument was a security instrument or not, one truly murky area of this issue was whether options, warrants, and stock rights were securities. This issue was clarified for taxpayers by the Treasury Regulations. In 1998, the Treasury issued final regulations that stated that rights to acquire stock pursuant to certain tax-free reorganizations and divisions were securities with zero principal amounts. §§ 1.354-1(e) (as amended in 2000), 1.355-1(c) (as amended in 2000), 1.356-3(b) (as amended in 2000).

Security instruments represent a type of investment in a corporation that is not quite an equity interest but has more ownership attributes in the corporation than a non-security debt instrument.[44] A holder of a security instrument will generally have more of an interest and participation in the long-term growth of a corporation than the holder of a short-term debt instrument characterized as a non-security debt instrument, but not as much participation as a holder of stock.[45] Although a security instrument clearly represents a debt interest and not an equity interest, the holder of a security instrument has more of a continuing interest in the corporation than a holder of a non-security debt instrument.[46] It is essentially a superior ownership interest to that of a non-security debt instrument.[47] Because of this heightened ownership interest, security instruments are included in the tax-free reorganization provisions.[48]

There is no easy, bright line rule to determine if a debt instrument is a security instrument. The term security instrument is not defined in the reorganization provisions. Instead, the determination must be made based on the facts and circumstances surrounding the debt instrument.[49] The factors a taxpayer would use to evaluate whether a debt instrument is a security instrument include the length of the term of the note, the continuing interest in the business represented by the note, and the degree of the holder's participation in a corporation.[50] Many courts have attempted to simplify the determination by creating and applying a bright line, length of time test based on the term of the note.[51] Such a test, however, has proven to be insufficient because the other terms of the debt instrument may or may not be consistent with a security instrument and the continuing interest requirement imposed on a security holder.[52]

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44. *See* Camp Wolters Enters., Inc. v. Comm'r, 230 F.2d 555, 560 (5th Cir. 1956) ("It is not necessary for the debt obligation to be the equivalent of stock since Sec. 112(b)(5) specifically includes both 'stock' and 'securities.'").

45. *See id.*

46. *See id.* The Treasury Regulations specifically provide that "a short-term purchase money note is not a security." Treas. Reg. § 1.368-1(b) (as amended in 2005).

47. *See* Pinellas Ice & Cold Storage Co. v. Comm'r, 287 U.S. 462, 469-70 (1933); *Camp Wolters*, 230 F.2d at 560.

48. *See supra* notes 44-47 and accompanying text.

49. *See Camp Wolters*, 230 F.2d at 560.

50. *See id.*

51. *See Pinellas*, 287 U.S. at 469 (holding that short-term notes payable within four months were not securities); Neville Coke & Chem. Co. v. Comm'r, 148 F.2d 599, 602-03 (3d Cir. 1945) (holding that three-, four-, and five-year notes were not securities); Lloyd-Smith v. Comm'r, 116 F.2d 642, 643 (2d Cir. 1941) (holding that two-year notes were not securities); *see also* BITTKER & EUSTICE, *supra* note 43, ¶ 12.41[3].

52. *See Camp Wolters*, 230 F.2d at 560 (approving the Tax Court's decision that "'[t]he test as to whether notes are securities is not a mechanical determination of the time period of the note. Though time is an important factor, the controlling consideration is an overall evaluation of the nature of the debt, degree of participation and continuing interest in the

In addition, Revenue Ruling 2004-78 dismissed any possibility of a clear-cut time test by holding that a relatively short-term debt instrument was in fact a security instrument because of the nature of the instrument.[53] Determining whether a debt instrument is a security instrument or a non-security debt instrument is integral to resolving whether a taxpayer will qualify for tax-free treatment under the reorganization provisions. Defining the term security, however, has become increasingly complicated and imprecise because of the lack of an obvious rule.[54]

Courts have hinged the determination in the tax-free reorganization context of whether a debt instrument is a security instrument or a non-security debt instrument ultimately on whether the holder has a continuing interest in the corporation.[55] By requiring that the security holder manifest a continuing interest in the corporation, courts have created a type of hybrid ownership interest that falls between an equity interest and a debt interest. To qualify as a security instrument, a debt instrument must represent a long-term ownership interest in the corporation that reflects a continuing proprietary interest.[56]

The continuity of interest requirement for security instruments was derived from the Supreme Court test in *Pinellas Ice & Cold Storage Co. v.*

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business'"); *see also* Rev. Rul. 2004-78, 2004-31 I.R.B. 108, 109 (holding that a two-year debt instrument qualified as a security instrument).

53. *See* Rev. Rul. 2004-78, 2004-31 I.R.B. 108, 109.

54. *See Pinellas*, 287 U.S. at 467; *Camp Wolters*, 230 F.2d at 560; Scofield v. LeTulle, 103 F.2d 20, 21-22 (5th Cir. 1939); Comm'r v. Freund, 98 F.2d 201, 204-05 (3d Cir. 1938); Burnham v. Comm'r, 86 F.2d 776, 776-77; Lilienthal v. Comm'r, 80 F.2d 411, 412-13 (9th Cir. 1935); Cortland Specialty Co. v. Comm'r, 60 F.2d 937, 940 (2d Cir. 1932).

55. *See Pinellas*, 287 U.S. at 470; *Freund*, 98 F.2d at 205; *Cortland*, 60 F.2d at 940. Interestingly, when the court lays out what might be considered a security, it cites some traits of an equity interest instead of a debt instrument. *See, e.g.*, *Pinellas*, 287 U.S. at 470. This confusion pervades much of the law in determining what a security instrument is. While this paper will not examine the debt/equity distinction as it is an equally unclear topic, it is interesting how that confusion pervades the attempt to define securities. *See id. But see* Erwin N. Griswold, *"Securities" and "Continuity of Interest,"* 58 HARV. L. REV. 705, 719-25 (1945) (contending that courts following *Pinellas*, in particular *Neville Coke & Chemical Co. v. Comm'r*, 148 F.2d 599 (1945), incorrectly applied the continuity of interest requirement to security instruments, further complicating the determination unnecessarily).

56. *See* LeTulle v. Scofield, 308 U.S. 415, 420-21 (1940) (noting particularly that the term of the debt instruments was immaterial); United States v. Hertwig, 398 F.2d 452, 455 (5th Cir. 1968); *Camp Wolters*, 230 F.2d at 560; Bedford v. Comm'r, 150 F.2d 341, 343 (2d Cir. 1945); Skenandoa Rayon Corp. v. Comm'r, 122 F.2d 268, 270 (2d Cir. 1941) (stating that dividend rights represented enough of a continuing interest in the corporation to constitute securities); L. & E. Stirn, Inc. v. Comm'r, 107 F.2d 390, 392 (2d Cir. 1939); Brown v. Comm'r, 27 T.C. 27, 36 (1956); Wellington Fund, Inc. v. Comm'r, 4 T.C. 185, 189 (1944) (holding that securities must represent participation in the business and not temporary advances to the corporation meant to meet current corporate needs).

Commissioner.[57] In *Pinellas*, the Supreme Court adopted a continuity of interest requirement for corporate reorganizations as was first laid out by the Court of Appeals for the Second Circuit in *Cortland Specialty Co. v. Commissioner.*[58] The continuity of interest requirement as applied to stockholders provides that the stockholders of the target corporation must have a continuing interest in the surviving corporation for a reorganization to qualify as tax free.[59] The continuity of interest requirement ensures that the intent of the stockholders is to preserve their ownership interest in the corporation rather than cashing out their investments through a tax-free reorganization.[60]

The Supreme Court in *Pinellas* decided two separate issues: (1) whether the reorganization was tax free based on whether the stockholders met the continuity of interest requirement; and (2) whether the debt instruments in the reorganization constituted security instruments.[61] Future courts, in interpreting the *Pinellas* case, commingled the two issues rather than interpreting the two issues separately as the Supreme Court handled them in its holding.[62] Courts following the *Pinellas* case held that in order to qualify as a security instrument, the holders of security instruments had to demonstrate a continuing interest in the corporation even though the holders of security instruments did not own an equity interest.[63] It is not clear from the Supreme Court's holding in *Pinellas* that this is what the Supreme Court intended.[64]

In *Pinellas*, the Supreme Court's discussion regarding whether the debt instruments were security instruments was therefore moot and an exer-

57. *Pinellas*, 287 U.S. at 470; *see also* Griswold, *supra* note 55, at 708; Comment, *Section 351 Transfers to Controlled Corporations: The Forgotten Term—"Securities,"* 114 U. PA. L. REV. 314, 319-20 (1965).

58. *Pinellas*, 287 U.S. at 470 (holding that the debt instruments were not security instruments because the holders of the debt instruments intended to sell their investment and cash out their investment rather than maintain a continuing interest); *Cortland*, 60 F.2d at 939-40.

59. *See* Treas. Reg. § 1.368-1(e) (as amended in 2005).

60. *See* § 1.368-1(e)(i).

61. *Pinellas*, 287 U.S. at 469-70; *see also* Griswold, *supra* note 55, at 707.

62. *See* Griswold, *supra* note 55, at 708-09, 718-25.

63. *See* Neville Coke & Chem. Co. v. Comm'r, 148 F.2d 599, 601-02 (3d Cir. 1945); Wellington Fund, Inc. v. Comm'r, 4 T.C. 185, 189 (1944); Rev. Rul. 59-98, 1959-1 C.B. 76, 77.

64. *Pinellas*, 287 U.S. at 469-70. In *Cortland*, the Court of Appeals for the Second Circuit stated that "[t]he word 'securities' was used so as not to defeat the exemption in cases where the interest of the transferor was carried over to the new corporation in some form." Cortland Specialty Co. v. Comm'r, 60 F.2d 937, 940 (2d Cir. 1932). If the Second Circuit is correct, and the intent of Congress behind including securities in the reorganization provisions was to ensure that as long as a holder is maintaining the same interest in the acquiring corporation that holder should have no gain or loss, then one cannot reconcile the tax treatment of security holders with that holders of non-security debt instruments.

cise in academic discourse. Later courts in interpreting the *Pinellas* case combined the two issues and imposed the continuity of interest requirement on security holders.[65] The court in *Burnham v. Commissioner*[66] stated, "[i]t is obvious that both Courts [in the *Pinellas* and *Cortland* holdings] based their decisions not so much on the ground that the short-term purchase money notes were not securities as that the transactions involved were not reorganizations."[67] The determination of whether the debt instruments were security instruments in the *Pinellas* and *Cortland* cases was actually irrelevant; the reorganizations did not qualify as tax free because the stockholders had not met the continuity of interest requirement irrespective of whether the instruments were security instruments.[68]

When the holder of a security instrument exchanges his debt instrument in the target corporation for an interest in the acquiring corporation that has identical rights to the debt instrument exchanged, the holder is continuing and maintaining an identical interest in the corporation. Although an identical interest is being maintained in the corporation, the tax consequences to the holder hinges on whether that interest is classified as a security instrument.

Courts have used several factors to determine whether a debt instrument represented a sufficient continuing interest to be classified as a security instrument. The most frequently cited factor for determining the continuing interest of a holder of a debt instrument was a "time test."[69] The time test based the determination of whether or not a debt instrument was a security instrument on the length of the term of the debt instrument.[70] In general, if a debt instrument had a term of more than ten

65. *See* Griswold, *supra* note 55, at 708-09, 718-25.

66. 86 F.2d 776 (7th Cir. 1936).

67. *Id.* at 776, 777.

68. *Pinellas*, 287 U.S. at 468–69; *Cortland*, 60 F.2d at 940.

69. *See infra* note 70 and accompanying text.

70. *See* Comm'r v. Tyng, 106 F.2d 55, 58-59 (2d Cir. 1939), *rev'd sub nom.* Helvering v. Tyng, 308 U.S. 527 (1940) (holding that twenty- and forty-year unsecured bonds were securities because they represented a long-term investment on the part of the transferor). The Second Circuit also dismissed the Commissioner's contention that whether or not a debt instrument was secured or unsecured was not the critical determination, but rather the length of the investment was the critical determination. *Id.* at 59; *see also* Neville Coke & Chem. Co. v. Comm'r, 148 F.2d 599, 602-03 (3d Cir. 1945) (holding that three-, four-, and five-year notes were not securities and even though the creditors sat on the board of directors and they did not have a sufficient proprietary interest in the corporation—but the court noted that time was not the determining factor); L. & E. Stirn, Inc. v. Comm'r, 107 F.2d 390, 392 (2d Cir. 1939); Comment, *supra* note 57, at 320-21. *But see* LeTulle v. Scofield, 308 U.S. 415, 420 (1940) (noting particularly that the term of the debt instruments was immaterial).

years, it was classified as a security instrument.[71] If a debt instrument had a term of less than five years, it was not a security instrument; rather, it was a regular debt instrument.[72] If a debt instrument had a term greater than five years and less than ten years, whether or not the instrument was a security instrument became a question of the facts and circumstances surrounding the debt instrument.[73]

Revenue Ruling 2004-78 dismissed the possibility of using a time test as a bright line rule to determine if a debt instrument was a security instrument.[74] In Revenue Ruling 2004-78, the Internal Revenue Service (IRS) ruled that a two-year debt instrument in the acquiring corporation was a security instrument, and therefore the holder was entitled to tax-free treatment on the exchange of his security instrument.[75] The IRS ruled that the two-year debt instrument could be considered a security instrument, even though, taken alone, a new debt instrument with a two-year term would generally not represent a continuing interest in the corporation sufficient to qualify the debt instrument as a security instrument.[76] The IRS reasoned that because the debt instrument received in the exchange had a two-year term that corresponded to the two-year term re-

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71. *See Burnham*, 86 F.2d at 776; Dennis v. Comm'r, 57 T.C. 352, 361-62 (1971) (holding that a debt instrument with a 12.5-year term was a security instrument); Nye v. Comm'r, 50 T.C. 203, 212 (1968) ("Basic to this settled rule [that promissory notes can be security instruments], is a requirement that the notes have a sufficiently long term to accord them an investment quality rather than the characteristics of cash. The latter characteristics may disqualify short-term notes as securities." (footnote omitted)); *see also* Wolf Envelope Co. v. Comm'r, 17 T.C. 471, 480 (1951); I.R.S. Tech. Adv. Mem. 6605266400A (May 26, 1966); KEVIN M. KEYES, FEDERAL TAXATION OF FINANCIAL INSTRUMENTS AND TRANSACTIONS ¶ 3.05[2][b][i] (1997).

72. *See* Comm'r v. Sisto Fin. Corp., 139 F.2d 253, 254, 256 (2d Cir. 1943); *L. & E. Stirn*, 107 F.2d at 392; Worcester Salt Co. v. Comm'r, 75 F.2d 251, 252 (2d Cir. 1935); *see also* Rev. Rul. 2004-78, 2004-31 I.R.B. 108, 109; I.R.S. Priv. Ltr. Rul. 8025081 (March 26, 1980); I.R.S. Priv. Ltr. Rul. 7928003 (March 23, 1979); I.R.S. Tech. Adv. Mem. 6605266400A; KEYES, *supra* note 71, ¶ 3.05[2][b][i].

73. *See* Camp Wolters Enters., Inc. v. Comm'r, 230 F.2d 555, 560 (5th Cir. 1956) (affirming the Tax Court's holding that five- to nine-year notes are securities); *Neville*, 148 F.2d at 601-02 (holding that the term was not the determining factor and that the proprietary interest of the creditor should be the determining factor); Comm'r v. Freund, 98 F.2d 201, 203-06 (3d Cir. 1938); Brown v. Comm'r, 27 T.C. 27, 36 (1956) (stating that the length of time is not the only consideration, but rather an overall evaluation of whether the debt instrument evidences a continuing interest); Pan Am. Trust Co. v. Comm'r, 4 T.C.M. (CCH) 555 (1945); Rev. Rul. 59-98, 1959-1 C.B. 76, 76-77; Comment, *supra* note 57, at 320; *see also* I.R.S. Field Service Advisory, Sept. 22, 1993, 1993 WL 1469500 ("There is no bright line with respect to the minimum term required in order to classify a debt instrument as a security. The Service will generally not consider a debt instrument with a term of less than 10 years as a security."); BITTKER & EUSTICE, *supra* note 43, ¶ 12.41[3]; KEYES, *supra* note 71, ¶ 3.05[2][b][i].

74. *See* Rev. Rul. 2004-78, 2004-31 I.R.B. 108, 108-09.

75. *See id.* at 109.

76. *See id.*

maining on the security instrument given up in the exchange, the new debt instrument could also be classified as a security instrument.[77]

The reorganization provisions require that for tax-free treatment in the case of an exchange of security instruments, one security instrument must be exchanged for another security instrument.[78] There is a certain logic behind the IRS' decision in Revenue Ruling 2004-78 because the debt instrument that the taxpayer gave up in the exchange had the same remaining term in the corporation as the debt instrument that the taxpayer received, and therefore, what the taxpayer received was similar to what the taxpayer gave up. Congress, however, did not draft section 354 to provide that an exchange of *similar* instruments would be entitled to tax-free treatment. Exchanges of debt instruments are not entitled to tax-free treatment just because the terms of the debt instruments received mirror the terms of the debt instruments given up in the exchange.[79] Rather, Congress required that a security instrument be received in exchange for giving up a security instrument.[80] Therefore, as the statute makes clear, the debt instrument received in the exchange must qualify as a security instrument independent of the instrument given up in the exchange.[81]

The IRS has acknowledged that a two-year debt instrument is generally insufficient to constitute a security instrument.[82] However, the IRS still ruled that a two-year debt instrument qualifies as a security instrument if the terms of the debt instrument are sufficiently similar to the surrendered security instrument.[83] This ruling, therefore, implies that the test for a security instrument must only be made for one debt instrument, provided that the debt instrument received in the exchange is similar enough to the security instrument given up at the time of the exchange.

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77. *See id.*

78. *See* I.R.C. § 354(a) (2006).

79. Ironically, this is precisely what section 1001 of the Code and the debt modification rules in Treasury Regulation section 1.1001-3 provide in the case of an exchange of a non-security debt instrument (or an exchange of debt instruments outside of a reorganization context). *See* discussion *infra* Part IV.B. It should be noted, however, that even if this was the rule that Congress had intended, the exchange in Revenue Ruling 2004-78 still would not have qualified as a tax-free exchange because, as reflected in the Revenue Ruling, the terms of the two debt instruments were sufficiently different that they would have constituted a significant modification and therefore a sale or exchange under section 1001. *See* Rev. Rul. 2004-78, 2004-31 I.R.B. 108, 108-09; *see also* I.R.C. § 1001(a); Treas. Reg. § 1.1001-3(b) (as amended in 1996).

80. *See* I.R.C. § 354(a).

81. *See id.*

82. *See* Rev. Rul. 2004-78, 2004-31 I.R.B. 108, 109.

83. *Id.* Note that the terms were different enough that, as acknowledged by the IRS, the exchange would have qualified as a significant modification under section 1001 and would have otherwise have constituted a sale or exchange. *See id.* at 108.

Perhaps requiring only one side of the exchanged debt instruments to qualify as a security instrument makes sense. This approach is logical because what the taxpayer is giving up in the exchange is so similar to what the taxpayer is receiving. Although this approach is logical, this approach does not address the requirements of the statute—that one security instrument is exchanged for another. In addition, because a debt instrument with a relatively short term can be classified as a security instrument, there is no longer a reliable bright line time test.

Revenue Ruling 2004-78 erodes the definition of a security instrument. By diminishing the standard for the determination of a security instrument to a very low threshold test, essentially any debt instrument could fall within the reorganization provisions. This will, in turn, further prevent the recognition of losses and require the recognition of gain. Had Congress intended the term security instrument to be so inclusive, it would have stated that an exchange of "stock or any debt instrument" will be entitled to tax-free treatment so long as the interests being exchanged were substantially identical rather than limiting the favorable treatment to an exchange of "stock or securities."[84]

There is no clear answer for many debt holders trying to determine what type of instrument they own. Although applying a continuity of interest standard to determine if an interest was a security instrument may have been inappropriate, it became critical to the classification of a security instrument.[85] The leading factor to demonstrate a continuing interest in a corporation by a debt holder was the length of the term of the debt instrument.[86] A holder cannot rely on a time test, however, after Revenue Ruling 2004-78, and must instead consider other factors.[87] The test for a security instrument is not a mechanical "time-test," but rather is based on all of the factors surrounding the note, such as the term of the note, the "degree of participation and continuing interest in the business," the purpose of the note, the risk taken by the debt holders, and similar considerations.[88] In addition, if a security instrument is given up in the exchange, the debt instrument received may be deemed to be a security instrument if its terms are similar enough to the exchanged secu-

84. *See* I.R.C. § 354(a).

85. *See* LeTulle v. Scofield, 308 U.S. 415, 420-21 (1940); United States v. Hertwig, 398 F.2d 452, 455 (5th Cir. 1968); Camp Wolters Enters., Inc. v. Comm'r, 230 F.2d 555, 560 (5th Cir. 1956); Bedford v. Comm'r, 150 F.2d 341, 343 (2d Cir. 1945); L. & E. Stirn, Inc. v. Comm'r, 107 F.2d 390, 392 (2d Cir. 1939); Wellington Fund, Inc. v. Comm'r, 4 T.C. 185, 189 (1944).

86. *See* Comm'r v. Tyng, 106 F.2d 55, 58-59 (2d Cir. 1939), *rev'd sub nom.* Helvering v. Tyng, 308 U.S. 527 (1940); Dennis v. Comm'r, 57 T.C. 352, 361-62 (1971); Nye v. Comm'r, 50 T.C. 203, 212 (1968); Wolf Envelope Co. v. Comm'r, 17 T.C. 471, 480 (1951); I.R.S. Tech. Adv. Mem. 6605266400A (May 26, 1966).

87. *See* Rev. Rul. 2004-78, 2004-31 I.R.B. 108, 109.

88. *See Camp Wolters*, 230 F.2d at 560.

rity instrument even if the debt instrument would not have independently qualified as a security instrument.[89]

B. Treatment of Debt-for-Debt Exchanges in a Tax-Free Reorganization

In a tax-free reorganization, stockholders can exchange stock in the target corporation for stock in the acquiring corporation without tax consequences.[90] The general rule is that a taxpayer will not recognize gain or loss on an exchange of stock or securities from one corporation that is a party to a reorganization, for stock or securities in either the same corporation or in another corporation that is also a party to a reorganization.[91] The reorganization provisions, which provide for a tax-free exchange of stock or securities, were enacted to ensure that transactions that were merely on paper would not have tax consequences to the taxpayer.[92] Congress did not want to interfere with business adjustments or tax individuals on "technical gain" that they might have when, in fact, they realized no cash profit.[93] Once taxpayers eventually converted their ownership interests in the corporation into cash, they would have to pay tax on the inherent gain. Until the taxpayers "cashed out" their investment, though, Congress thought the taxpayer should not have to pay tax on the gain.[94]

Prior to the enactment of the tax-free reorganization provisions, the tax treatment of an exchange of property, including security instruments, was to treat the exchange as a taxable sale or exchange with the fair market value of the property received considered the equivalent of cash.[95] As a result, the taxpayer would recognize gain or loss on the exchange.[96] Congress changed the tax consequences to taxpayers of an exchange of stock and securities in the context of a tax-free reorganization and provided instead that an exchange of stock or securities would be tax free until the stock or securities in the reorganized corporations were ultimately sold

89. *See* Rev. Rul. 2004-78, 2004-31 I.R.B. 108, 109.

90. *See* §§ 354(a), 368.

91. *See* § 354(a)(1).

92. *See* S. REP. NO. 65-617, at 5-6 (1918). Since 1918, the distinction for recognizing gain in the case of security instruments was for security instruments with a "par value" or face value higher than the par value or face value security instrument given up in the exchange. *See* H.R. REP. NO. 65-1037, at 44-45 (1919) (Conf. Rep.). For a thorough discussion of the legislative history behind the reorganization provisions, as well as a critique of the current taxing structure of reorganizations, see Yariv Brauner, *A Good Old Habit, or Just an Old One? Preferential Tax Treatment for Reorganizations*, 2004 BYU L. REV. 1, 52-68 (2004).

93. *See* S. REP. NO. 67-275, at 11 (1921).

94. *See id.* at 11-12; S. REP. NO. 65-617, at 5-6 (1918).

95. *See* H.R. REP. NO. 65-1037, at 44-45; S. REP. NO. 65-617, at 5-6.

96. *See* H.R. REP. NO. 65-1037, at 44-45; S. REP. NO. 65-617, at 5-6.

and the taxpayer had "cashed out."[97] Congress determined that it was necessary to enact this amendment because "no part of the present income tax law has been productive of so much uncertainty or has more seriously interfered with necessary business readjustments."[98] Congress also stated that taxing such exchanges was "economically unsound."[99]

Section 354(a)(1) provides that an exchange of security instruments will be tax free to a taxpayer if the exchange takes place pursuant to a tax-free reorganization.[100] This tax-free treatment is limited, however, and non-recognition treatment of taxable gain will not apply, if the principal amount of the security instrument received exceeds the principal amount of a security instrument surrendered.[101] The principal amount of a debt instrument is generally equal to the debt instrument's face amount, which is equal to the amount of principal payments that will be made on a debt instrument through maturity.[102]

Congress wanted to avoid taxing purely paper transactions, such as an exchange of security instruments in a tax-free reorganization, and to encourage businesses to restructure when necessary.[103] Through amendments to the reorganization provisions, however, Congress has slowly eroded away at the tax-free treatment afforded to security instruments and has begun to tax gains on these exchanges while preventing losses.[104]

During the Great Depression, a proposal to fully tax reorganizations was dismissed. It became clear that Congress was more concerned with preventing taxpayers from taking losses than either allowing businesses to restructure without the fear of tax consequences or taxing taxpayers purely on paper gains.[105] Rather, as the legislative history indicates, Congress was concerned not with what the proper or correct tax treatment to tax-free exchanges was, but rather with the revenue loss that making

97. *See* H.R. REP. NO. 73-704, at 13 (1934); S. REP. NO. 67-275, at 11-12; H.R. REP. NO. 65-1037, at 44-45; S. REP. NO. 65-617, at 5-6.

98. S. REP. NO. 67-275, at 11.

99. *Id.* The discussion of the amendment in 1921 to section 202(c) concerned not only the reorganization provision, but also the provision enacting like-kind exchanges. *See id.* Exchanges of property of a like kind are not subject to recognition of gain or loss if property is "held for productive use in a trade or business or for investment." I.R.C. § 1031 (2006).

100. § 354(a)(1).

101. *See* § 354(a)(2)(A). Stock rights are classified as securities with zero principal amount. *See* Treas. Reg. § 1.354-1(e) (as amended in 2000).

102. *See* H.R. REP. NO. 65-1037, at 44-45 (referring to the face amount of the debt). The principal of a debt instrument is the portion of the debt that is not interest. BLACK'S LAW DICTIONARY 1231 (8th ed. 2004).

103. *See* S. REP. NO. 67-275, at 11-12; S. REP. NO. 65-617, at 5-6 (1918).

104. *See generally* H.R. REP. NO. 83-1337, at 39-41 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4017, 4221.

105. *See* H.R. REP. NO. 73-704, at 12-13 (1934); S. REP. NO. 67-275, at 11-12; S. REP. NO. 65-617, at 5-6.

these exchanges taxable would cause.[106] Although the economic climate has changed dramatically since that debate, the inclusion of securities in the tax-free reorganization provisions has not.

Even though security instruments are initially included in tax-free reorganization provisions pursuant to the language in section 354(a), an exchange of security instruments is not actually tax free.[107] If a taxpayer receives cash or property in a tax-free reorganization, other than stock or securities, the taxpayer has "boot."[108] If a taxpayer receives boot, he is taxed on that boot to the extent of the fair market value of the boot received or his realized gain, whichever amount is less.[109] Boot not only includes money or property the taxpayer receives in the exchange, but also includes some amounts from an exchange of security instruments.[110] If the principal amount of the security instrument received is greater than the principal amount of the security instrument given up in the exchange, then the taxpayer is taxed on the fair market value of the excess of the principal amount received over the principal amount of the debt instrument given up.[111]

It may be true that holders of security instruments have some tax advantages in a tax-free exchange in the context of gain because the taxpayers are taxed on the increased value of the principal amount that they are receiving rather than the full amount of their realized gain.[112] However, the principal amount of a debt instrument is not tied to how much the taxpayer paid for the security instrument or what the fair market value of the security instrument is at the time of the exchange; therefore, the gain that a taxpayer recognizes on an exchange of security instruments does not reflect the actual amount of gain a taxpayer has on the exchange.[113] The fair market value of a debt instrument is tied not only to the princi-

106. *See* H.R. REP. NO. 73-704, at 1, 10.

107. *See* I.R.C. §§ 354(a)(2), 356(d)(2)(B) (2006).

108. *See* § 356(a). Essentially, boot is additional cash or property that the taxpayer receives in an exchange beyond simply stock or securities permitted to be received in a reorganization tax-free. *See id.*; *see also* BLACK'S LAW DICTIONARY 195 (8th ed. 2004).

109. *See* I.R.C. § 356(a). In certain cases, boot may be treated as a dividend to the taxpayer. *See* § 356(a)(2). Boot, however, will not be treated as a dividend if received by a security holder who is not a stockholder. *See* Rev. Rul. 71-427, 1971-2 C.B. 183, 184 (ruling that section 356(a)(2) was inapplicable to the receipt of boot by a debenture holder).

110. *See* I.R.C. § 356(d)(2)(B).

111. *See id.* The tax only applies if the realized gain is at least equal to the fair market value of the excess principal amount. *See* § 354(a)(2)(A). The fair market value of the excess principal amount is treated as boot. *See* §§ 354(a)(2), 356(d)(2)(B); Treas. Reg. § 1.356-3(a) (as amended in 2000). If the taxpayer has any realized gain on the reorganization, he will recognize gain on the boot to the extent of the gain. *See* I.R.C. § 356(a)(1). If, however, the taxpayer does not have a realized gain on the reorganization, he will not recognize any gain on the distribution of the boot. *See id.*

112. *See* § 356(d)(2)(B).

113. *See* Land, *supra* note 28, at 62.

pal amount of the debt instrument but also to several other factors, such as the interest rate on the debt instrument, the term, the financial and credit status of the corporation, and the current market interest rate.[114] Because the statute provides that taxpayers should calculate gain on the basis of only the principal amount, the gain the taxpayer recognizes does not accurately reflect the taxpayer's actual economic gain.

Congress included the provision that holders of security instruments are taxed on the excess principal amount of security instruments exchanged because Congress wanted to tax the additional principal amount.[115] Since the principal amount represents what the debt holder receives if the corporation liquidates, this amount represented a greater underlying interest in the corporation. By receiving an additional right to principal, the debt holder has a greater interest in the underlying corporation. Congress wanted to tax this additional amount without requiring the taxpayer to recognize the entire amount of inherent gain he might have with respect to the security instrument.[116] Because the computation of gain does not, however, take into account other factors—such as interest rates, terms, or credit-worthiness of the corporation—it is not an accurate reflection of the taxpayer's actual economic gain.

The taxpayer will not recognize gain or loss on the exchange, even if the fair market value of the two interests is different, as long as the principal amounts of the security instruments exchanged are the same.[117] If the principal amount of the security instrument received in an exchange is greater than the principal amount of the security instrument given up,

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114. *Cf. id.*

115. *See* H.R. REP. NO. 83-1337, at 39-41 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4017, 4060, 4221 (citing Comm'r v. Neustadt's Trust, 131 F.2d 528 (2d Cir. 1942)).

116. *Id.*

117. For example, if a taxpayer held a security instrument in a distressed company, the security instrument would not have a fair market value equal to its principal amount because the market would take into account the likelihood (or lack thereof) of a possibility of repayment; therefore, it is likely that the fair market value of the debt instrument might be less than the principal amount. If, in the exchange, the unstable company is acquired by a wealthy, stable financial company, the fair market value of the new debt instrument with the same face value could be worth significantly more than the principal amount because the market would factor in the likelihood of being paid on the principal amount. Therefore, the principal amounts are not truly representative of what a taxpayer is either receiving or giving up; and yet, these amounts are used to determine the amount of gain.

If section 354 applies, and the holder does not recognize any gain, his basis in the new debt instrument will be a transferred basis, meaning that it will be equal to the basis of the security instrument he gave up in the exchange. *See* I.R.C. § 358(a)(1). In addition, the taxpayer will be able to carryover his holding period from the old security instrument. *See* § 1223(1). If the holder of a security instrument recognizes gain on the exchange of a security instrument, then his adjusted basis in the new security instrument will be equal to the adjusted basis in the old security instrument, reduced by the fair market value of the excess principal amount received and increased by the amount of any gain recognized on the exchange. *See* § 356(a)(1).

the taxpayer will recognize gain equal to the fair market value of the excess principal amount, irrespective of whether the taxpayer actually has any economic gain or loss on the exchange.[118] This tax treatment appears to be contradictory to the earlier concerns of Congress, that taxing reorganizations would be "economically unsound."[119] Rather, it appears that by including security instruments in the reorganization provisions Congress has unintentionally created the "economically unsound" conditions about which it was concerned by taxing gains that are simply on paper.[120]

Indeed, Congress actually has created an economically unsound position. Even though a holder of a security instrument has taxable gain that he must recognize under the Code, he might actually have an economic loss if the security instrument he receives in the exchange is worth less than what he paid for his original security instrument. The taxpayer is better off selling his investment than participating in the exchange because the taxpayer would then be able to recognize his loss and can avoid recognizing gain. This makes participation in the reorganization provisions for holders of security instruments economically unsound. Instead, taxpayers are better off not participating in the reorganization. This discourages their continuing interest in the corporation and instead encourages them to cash out their investment, which is inconsistent with Congress' goal to promote long-term investments.

In a straight taxable exchange, the taxpayer may have a recognized loss, even though the principal amount of the debt instrument received may be more than the principal amount of the debt instrument exchanged. If, instead, the same exchange is given tax-free treatment under the reorganization provisions, although the taxpayer has an economic loss, the taxpayer must recognize, and pay tax on, a gain.[121]

118. *See* §§ 354(a)(2), 356(d)(2)(B). Sections 354(a)(2)(A) and 356 also discuss the fair market value of excess principal amount. *See* Treas. Reg. § 1.356-3(a) (as amended in 2000); MICHAEL J. KLIEGMAN, SINGLE ENTITY REORGANIZATIONS: RECAPITALIZATIONS AND F REORGANIZATIONS A-32 (2001). In addition to the fair market value of the excess principal amount of securities received in a tax-free reorganization, if the holder receives any amounts in exchange for any interest accrued (including any accrued OID) on the security instrument as of the date of the exchange, the holder must include those amounts in income. *See* I.R.C. § 354(a)(2)(B). If, however, the taxpayer does not have any economic gain on the reorganization because the fair market value of the stock and securities received is less than his adjusted basis in the stock and securities exchanged, the taxpayer could immediately turn around and sell the debt instruments or cause the corporation to retire the bonds under section 1271. *See* BITTKER & EUSTICE, *supra* note 43, ¶ 12.27[5][a]. This possibility, which was created by the tax consequences to security holders, is not consistent with current public policy to encourage maintaining long-term investment in corporations.

119. *See* S. REP. NO. 67-275, at 11-12 (1921).

120. *See supra* notes 115-18 and accompanying text.

121. *See* I.R.C. §§ 354(a)(2), 356(c), (d)(2)(B).

In an exchange of debt instruments that does not qualify for tax-free treatment, a taxpayer is taxed on the difference between the taxpayer's adjusted basis in the security instrument and the fair market value of the debt instrument that he receives in the exchange.[122] If a taxpayer is exchanging stock or securities pursuant to a tax-free reorganization in addition to his exchange of boot, then the taxpayer will still have to recognize gain and will also be prevented from recognizing loss, just as holders of security instruments are precluded.[123]

C. The Corporation's Tax Consequences

Most of the discussion thus far has been focused on the tax consequences to a holder of a security instrument rather than on the tax consequences of the corporation issuing the original or new security instrument. Issuing new security instruments does not generally have any tax consequences for the corporation.[124] A corporation will, however, have to recognize any cancellation of indebtedness income on the exchange.[125] As in a taxable debt-for-debt exchange, if the new debt instrument has an issue price in excess of the old debt instrument's issue price, the corporation will have cancellation of indebtedness income because the corporation has been relieved of that amount of debt.[126]

Cancellation of indebtedness occurs when a debt owed by a taxpayer is discharged.[127] Unless certain exclusions apply, the amount of the debt that the taxpayer is relieved from paying will be taxable as gross income.[128] Cancellation of indebtedness is determined by using the issue price of the security instruments exchanged.[129] The fact that an exchange of securities takes place in connection with a tax-free reorganization will not allow the corporation non-recognition of any cancellation of indebtedness income.[130] In other words, a corporation that exchanges an out-

122. *See* § 1001; Treas. Reg. §§ 1.1001-1(g) (as amended in 1996), 1.1001-3 (as amended in 1996), 1.354-1(d) ex. 4 (as amended in 2000). An exchange might be taxable, not only because debt instruments are not security instruments, but even if one debt instrument in the exchange is not a security instrument. Treas. Reg. § 1.356-3 (as amended in 2000).

123. *See* I.R.C. § 356(a)(1), (c).

124. In the case of an A, B, C, D, or F reorganization, section 361 provides for non-recognition to the corporation. *See* § 361. In the case of an E reorganization, section 1032 also provides for no recognition. *See* § 1032.

125. *See* § 61(a)(12).

126. *See* §§ 61(a)(12), 108(e)(10).

127. *See* § 108(e)(10).

128. *See* § 108(a), (e)(10).

129. *See* § 108(e)(10); Treas. Reg. § 1.108-1(d)(5) (as amended in 1996).

130. There is no exception for tax-free reorganizations in the exceptions for cancellation of indebtedness income in section 108. *See* I.R.C. § 108(a), (e)(10).

From 1984 to 1990, section 1275(a)(4) used the adjusted issue price of the old debt instrument as the floor on the issue price of the new debt instrument, and therefore, original issue discount of the new debt instrument could not exceed the original issue discount of standing security instrument for a new security instrument will have income equal to the amount that the corporation has been relieved of paying.[131] The corporation will have income equal to the amount that the adjusted issue price of the old security instrument exceeds the issue price of the new security instrument.[132]

As discussed earlier, the issue price of a security instrument may be less than the principal amount of a security instrument.[133] While the corporation is using the issue price of a security instrument to determine any cancellation of indebtedness income, the holder of the security instrument must use the principal amount of the security instrument to determine any gain on the exchange.[134] For example, a taxpayer might exchange a security instrument with a $1000 principal amount, an 8% interest rate, and a fair market value and issue price of $1000 for a new security instrument with a principal amount of $1050, a 6% interest rate, and a fair market value of $900.[135] The issue price of the new debt instrument would be the fair market value of the old debt instrument, here $1000.[136] The corporation will have $100 of cancellation of indebtedness income, even if the corporation has the ability and intention to pay the taxpayer the full $1050 principal amount on the due date.[137] In addition, the taxpayer will have gain equal to the fair market value of the $50 excess principal amount.[138]

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the old debt instrument—unless the stated redemption price at maturity had also increased in the debt exchange. *See* I.R.C. § 1275(a)(4) (1985); I.R.C. § 1275(a)(4) (1990). The intent behind this provision was to lower the amount of OID and cancellation of indebtedness income in a security for security recapitalization in the case of financially distressed companies. *See* BITTKER & EUSTICE, *supra* note 43, ¶ 12.27[4][b]. In 1990, section 1275(a)(4) was amended to provide that in recapitalizations, security exchanges were to be treated in the same manner as regular debt exchanges for purposes of original issue discount and cancellation of indebtedness income—using the same issue price determination rules under sections 1273 and 1274. *See id.*

131. *See* I.R.C. § 61(a)(12). For the purposes of this Article, the corporations discussed are not insolvent or in bankruptcy; therefore, the exceptions from cancellation of indebtedness income contained in section 108(a)(1)(A) and (B) will not be discussed.

132. *See* § 108(e)(10).

133. *See supra* note 117.

134. *See* §§ 108(e)(10), 354(a)(2), 356(d)(2)(B); Treas. Reg. § 1.108-1(d)(5) (1994).

135. The fair market value of a security instrument with a $1000 principal amount and an 8% interest rate might be $900 if the current going interest rate for debt instruments is at 12%.

136. *See* I.R.C. § 1273(b)(3).

137. When the corporation does pay the $50 of principal amount above the issue price, it will be taxed to the taxpayer as interest. *See* §§ 61(a)(4), 354(a)(2)(B).

138. *See* § 354(a)(2)(B). Prior to 1984, when a corporation exchanged its outstanding debt instruments for stock, it was non-taxable to both the debt holders or stockholders and the corporation, with an exception for cancellation of indebtedness income. *See* I.R.C. § 108(e) (1983). In 1984, Congress limited the exception for cancellation of indebtedness income to insolvent and bankrupt corporations. Deficit Reduction Act of 1984, Pub. L.

IV. TREATMENT OF TAXABLE DEBT-FOR-DEBT EXCHANGES

A. Debt-for-Debt Exchanges

To examine and critique the tax treatment of an exchange of security instruments in corporate reorganizations, it is necessary to examine the tax treatment of a fully taxable exchange of debt instruments outside of the tax-free reorganization context. An exchange of one debt instrument for another debt instrument will be fully taxable if it is treated as a sale or exchange for tax purposes.[139] In a tax-free reorganization, if a taxpayer does not hold stock or securities but holds non-security debt instruments, and exchanges them pursuant to the reorganization, the taxpayer will be subject to the sale or exchange provisions applicable to a debt exchange outside of the reorganization context.[140] The taxpayer's exchange of debt instruments will be taxed the same whether or not the exchange is pursuant to a tax-free reorganization.[141]

No. 98-369, § 59, 98 Stat. 494, 576. Then, in 1993, Congress repealed this exception all together. *See* Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13226, 107 Stat. 416, 487. Thereafter, corporations were treated as though they bought the debt instruments back for an amount equal to the fair market value of the stock that the corporation exchanged. I.R.C. § 1273(b). Any amount that the principal amount of the debt instrument exceeded the fair market value of the stock given up was cancellation of indebtedness income to the corporation. § 61(a)(12).

139. *See* § 1001(c).

140. *See* §§ 354(a), 1001(c).

141. This is assuming that the taxpayer did not also exchange additional stock or securities in the reorganization. Otherwise, the taxpayer would still be precluded from recognizing the loss. *See* § 356(c).

The restriction on the recognition of losses is not limited to an exchange of security instruments; rather, it extends to other types of exchanges as well. Whether a taxpayer is permitted to recognize a loss in connection with a tax-free reorganization hinges not only on whether the exchange of security instruments is for other security instruments (or stock exchanged for other stock), but also if there is an exchange of other types of property. If a corporation is engaged in a tax-free reorganization and a person exchanges stock or securities for cash or for any other property that does not qualify in the reorganization, the taxpayer has gain or loss equal to the difference between the taxpayer's adjusted basis in the stock or securities and the amount of cash or the fair market value of the property the taxpayer received. *See* § 356(a)(1). Unlike an exchange of stock for stock, or security instruments for security instruments, a taxpayer in such an exchange could recognize a loss realized on the exchange. The tax consequences of exchanges in tax-free reorganizations that do not qualify for tax-free treatment, or semi-tax-free treatment, are logical and consistent with the way sales and exchanges are normally taxed in the case of taxable gain. *See* § 1001.

If, however, a taxpayer exchanged stock for stock, or a security instrument for a security instrument, pursuant to a tax-free reorganization and then also exchanged stock and a security instrument for a non-security debt instrument, the taxpayer would have to recognize any gain on the exchange of the stock or security instrument for the non-security debt instrument and once again, would not be able to recognize a loss. *See* § 356(a), (c). This tax treatment would be the same whether the property received in the exchange was a non-security debt instrument, cash, or another type of property. *See* § 356(a)(1), (c). The

Often an exchange of debt instruments can take place for tax purposes when the taxpayer has, in fact, exchanged nothing from a practical standpoint. Rather, the taxpayer holds exactly the same piece of paper that he held before the exchange. The taxpayer may participate in a taxable exchange even though he may still hold exactly the same debt instrument in exactly the same corporation; the only change is that the corporation has notified the taxpayer that the term of the debt instrument has changed, or that the land securing the debt instrument has been sold and new property is securing the debt instrument.[142] Because the ownership rights of the holder of the debt instrument have been changed or altered, this is treated as a sale or exchange, even though from the taxpayer's perspective, he still owns the same debt instrument in the same company that he owned before the "exchange."[143]

Alternatively, the taxpayer may actually exchange his debt instrument in the target corporation for a new debt instrument in an acquiring corporation, which issues the taxpayer a new debt instrument pursuant to the reorganization. From the taxpayer's perspective, the taxpayer owns a new debt instrument in a new company. For tax purposes, however, as long as the terms of the new debt instrument remain the same—such as the interest rate, the payment schedule, and the term—then even though a new corporation will be making payments to the taxpayer, because the debt instrument has not been significantly modified, there is no sale or exchange and therefore, no taxable event.[144]

Whether or not there is a taxable exchange depends on whether or not there has been a modification of the debt instrument.[145] If there has been a modification, the next question is whether the modification is significant.[146] The regulations under section 1001 dictate whether changes or modifications in a debt instrument are significant enough to constitute a

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taxpayer is now prevented from recognizing a loss that he could previously recognize simply because we have interjected into the exchange a tax-free exchange of stock or securities. *See* § 356(c).

If, in connection with a tax-free reorganization, a taxpayer exchanges stock in a corporation for a security instrument in the corporation, then the taxpayer will be deemed to receive an amount of boot equal to the fair market value of the security instrument. *See* §§ 354(a)(2)(A)(ii), 356(d). The taxpayer will therefore recognize gain equal to the difference between his adjusted basis in the stock surrendered in the exchange and the fair market value of the security instruments received in the exchange. *See* § 356(a)(1), (d)(1). This tax result appears to be appropriate and consistent with basic tax principles and the concept of a sale, exchange, or disposition under section 1001. *See* § 356(a)(1), (c), (d).

142. *See* Treas. Reg. § 1.1001-3(e)(2), (e)(4)(i), (e)(4)(iv) (as amended in 1996).

143. *See* § 1.1001-3(b). This is assuming that the changes to the taxpayer's ownership rights in the debt instrument qualify as a "significant modification." *See* § 1.1001-3(a), (b).

144. *See* § 1.1001-3 (b), (e)(4)(i)(C).

145. *See* § 1.1001-3(a)-(c).

146. *See* § 1.1001-3(b), (e)-(f).

sale or exchange and therefore taxable.[147] For purposes of determining whether there has been a significant modification and a taxable exchange, the characterization of a debt instrument as a security instrument, as opposed to a non-security debt instrument, is completely irrelevant.[148]

The rules under section 1001 apply to a taxable exchange of debt instruments, including both exchanges that take place in a reorganization that do not actually qualify for tax-free treatment and straight taxable exchanges of debt instruments outside of the tax-free reorganization context.[149] In a taxable exchange of debt instruments, the holder may recognize gain or loss,[150] the corporation that issued the original debt instrument may have cancellation of indebtedness income,[151] and the holder may also have original issue discount (OID),[152] market discount, or bond premium in the new debt instrument.[153]

B. Modifications Under Section 1001

In general, an exchange of debt instruments will only trigger gain or loss if the exchange constitutes a sale or disposition under section 1001.[154] An exchange of debt instruments will constitute a sale or disposition if the new debt instrument is materially different "in kind or in extent" from the old debt instrument.[155] The Treasury Regulations under section 1001 provide that a debt instrument will be materially different if there is a significant modification of the debt instrument that results in a sale or exchange of the debt instruments.[156] There is essentially a two-part test to determine whether the debt instruments are materially different. The first test examines the terms of the debt instrument to determine whether there has been a "modification."[157] Any modification of a debt instru-

147. *See* § 1.1001-3(a), (b), (e).

148. *See supra* notes 145-47 and accompanying text. Of course, if an exchange is pursuant to a tax-free reorganization, then an exchange of security instruments will not be subject to the provisions of section 1001 and instead will be taxed according to the tax-free reorganization provisions as discussed earlier. *See* I.R.C. §§ 354(a), 1001(a) (2006). Assuming, however, that an exchange is outside of the tax-free reorganization context, whether or not a debt instrument is a security instrument is completely irrelevant for purposes of calculating gain under the section 1001 provisions. *See* § 1001.

149. *See* § 1001(a).

150. § 1001(c).

151. § 61(a)(12).

152. § 1272(a).

153. *See* § 1278(a); Treas. Reg. § 1.1275-1(b)(2) (as amended in 2002).

154. *See* I.R.C. § 1001(a); Treas. Reg. §§ 1.1001-1(a) (as amended in 1996), 1.1001-3(a) (as amended in 1996).

155. *See* Treas. Reg. § 1.1001-3(a)-(b).

156. *See* § 1.1001-3(b).

157. *See* § 1.1001-3(c). Treasury Regulation 1.1001-3 lays out the basic framework to determine if a new debt instrument is materially different from the old debt instrument. *See generally* § 1.1001-3.

ment—whether the modification is the result of an express agreement between the taxpayer and the corporation or is otherwise modified such as by the conduct of the parties—will be considered when determining whether there has been a sale, exchange, or disposition for tax purposes.[158] If there has been a modification, then the second test will be applied to determine whether the modification was a significant modification.[159] If there has simply been a modification of a debt instrument, but the modification does not rise to the level of a significant modification, then there will not be a taxable sale or exchange of the debt instruments.[160]

A modification of a debt instrument is essentially any change to the rights or obligations of either the holder or the issuer of the debt instrument.[161] Examples of a modification of a debt instrument are changes to: the length of the term of the debt instrument, the obligor on the debt instrument, the interest rate, or the type or amount of property securing the debt instrument.[162] Once it is determined that there has been a modification to the terms of the debt instrument, the next determination is whether the modification rises to the level of a significant modification that will trigger a sale or exchange.

A modification is considered significant if the rights and obligations of the holder or the issuer are changed or altered to such a degree that the modification is "economically significant."[163] The Treasury Regulations provide specific rules for determining whether a modification rises to the

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158. *See* § 1.1001-3(c)(1)(i).

159. *See* § 1.1001-3(e).

160. *See* § 1.1001-3(b). Because there has not been a sale or disposition for tax purposes, some commentators have argued that section 108(e)(10) is not implicated and therefore would not give rise to cancellation of indebtedness income. *See* 2 MARTIN D. GINSBURG & JACK S. LEVIN, MERGERS, ACQUISITIONS, AND BUYOUTS ¶ 605 (2004) (stating "[w]hile there is nothing in Code § 108(e)(10) that limits the application of that provision to an 'exchange' under Code § 1001, it would appear logical that the Code § 1001 standard should govern" and preclude cancellation of indebtedness income).

Alternatively, the same commentators note that under section 108(e)(4), if a person is related to the corporation acquires its indebtedness from a holder, provided the holder is not related to the corporation, then the corporation will recognize cancellation of indebtedness "income to the extent [that] the adjusted issue price of the [debt instrument] exceeds the [acquiror's] adjusted basis in the [debt instrument] on the acquisition date." *Id.*; *see also* I.R.C. § 108(e)(4). The test for determining who is related to the corporation starts on the date the debt instrument is acquired, which, if applied in a tax-free reorganization, would give rise to cancellation of indebtedness income. *See* GINSBURG & LEVIN, *supra*, ¶ 605.

161. *See* Treas. Reg. § 1.1001-3(c)(1)(i); *see also* Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554, 565-67 (1991) (holding that there is a taxable exchange of debt instruments if the new properties are materially different, i.e., if the taxpayer enjoys new legal entitlements that were not present in the old property).

162. *See* Treas. Reg. § 1.1001-3(c)(2)(i), (d) exs. 8-9.

163. *See* § 1.1001-3(e)(1).

level of a significant modification in certain cases, such as a change in yield,[164] a change in payment dates,[165] a change in the obligor,[166] or a change in the amount of security for the debt instrument or a credit enhancement of the obligor.[167] In addition to these specific changes to a debt instrument's terms, if there are several modifications to a debt instrument that may not constitute a significant modification when taken alone but may constitute a significant modification collectively, they must be tested together to determine whether the modifications alter the debt instrument in an economically significant way.[168]

As mentioned above, the Treasury Regulations specifically discuss whether a change in obligor will constitute a significant modification.[169] A change of obligor in a debt instrument has different rules depending on whether the debt is a recourse debt or a non-recourse debt instrument.[170] A change of obligor in a non-recourse debt instrument will generally not constitute a significant modification.[171] In the case of a recourse debt instrument, a change in an obligor will generally constitute a significant modification subject to certain exclusions.[172] A change of an obligor on a recourse debt instrument will not be a significant modification if: (1) the new obligor acquired substantially all of the assets of the prior obligor,

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164. *See* § 1.1001-3(e)(2). A change in the yield of a debt instrument will be significant if the annual yield of the new debt instrument differs from the old debt instrument by more than the greater of twenty-five basis points or 5%. § 1.1001-3(e)(2)(ii).

165. *See* § 1.1001-3(e)(3). A change in the payment dates will be a significant modification if it results in a "material deferral" of scheduled payments. *Id.* There is a safe harbor in the regulations that provides that if the term of the debt instrument is only extended for the lesser of five years or 50% of the original term of the debt instrument, there will not be a material deferral and hence not a significant modification. § 1.1001-3(e)(3)(ii).

166. *See* § 1.1001-3(e)(4)(i)(A). However, certain changes in the obligor on a debt instrument will not constitute a significant modification. In particular, the substitution of a new obligor will not be a significant modification if the new obligor acquired substantially all of the assets of the former obligor. *See* § 1.1001-3(e)(4)(i)(C). The acquiring corporation in a tax-free reorganization will, in many cases, qualify as acquiring substantially all of the assets of the target corporation. *See* KEYES, *supra* note 71, ¶ 3.05(1)(c)(iv) (stating that "[a]s a policy matter, such changes [tax-free liquidations or mergers] alone should not be viewed as material").

167. *See* Treas. Reg. § 1.1001-3(e)(4)(iv). A change in the property securing the debt or the credit enhancement of the obligor occurs if there is a change in payment expectations. *Id.*

168. *See* § 1.1001-3(e)(1). The taxpayer must examine all of the facts and circumstances of the modification to determine whether or not the debt instrument's terms have been changed in an economically significant manner. *See id.*

169. *See* § 1.1001-3(e)(4)(i)(A).

170. *See* § 1.1001-3(e)(4)(i)-(ii).

171. *See* § 1.1001-3(e)(4)(ii), (iv)(B).

172. § 1.1001-3(e)(4)(i)(A).

such as in a reorganization; (2) there is not a change in payment expectations; and (3) there is not a significant alteration of the debt instrument.[173]

A change in payment expectations occurs if the corporation's ability to pay the debt instrument, as a result of the change or modification, has been substantially enhanced.[174] Substantial enhancement occurs when the corporation's ability to pay the debt instrument was speculative prior to the modification, and after the modification, the corporation's ability to pay the debt instrument is adequate.[175] Alternatively, it will also constitute a change in payment expectations if, prior to the modification, the corporation's ability to make the payments was adequate, and after the modification, the corporation's ability to make the payments is primarily speculative.[176]

If the modification is significant, the taxpayer will have a taxable exchange and will recognize gain or loss accordingly, and the corporation may recognize cancellation of indebtedness income.[177] If there has not been a significant modification, there will not be a taxable exchange, and the taxpayer will not recognize any gain or loss on the exchange.[178] Essentially, if the debt instrument's terms have not changed significantly, then the taxpayer owns the same property he owned previously and, therefore, there is not a taxable event.

For example, if a taxpayer holds a debt instrument of Target, and Target merges into Acquiring Corporation in a tax-free reorganization, with Acquiring gaining all of Target's assets and assuming all of Target's liabilities, the obligor on the taxpayer's debt instrument would change from Target to Acquiring. If the taxpayer held a security instrument in Target and in exchange received a security instrument in Acquiring, as described earlier, the taxpayer would recognize gain on the exchange equal to the fair market value of the excess principal amount but would not be able to recognize any loss.[179] The taxpayer would take a transferred basis in the new debt instrument, which would have an adjusted issue price equal to the fair market value of the debt instrument given up in the exchange.[180] Alternatively, if, in the same tax-free reorganization, the taxpayer exchanged a non-security debt instrument for another non-security debt instrument, the exchange would not qualify under the reorganization provisions and would therefore have to be examined under the regulations under section 1001. At this point, we would consider

173. *See* § 1.1001-3(e)(4)(i)(B), (C), (E).
174. *See* § 1.1001-3(e)(4)(iv)(A).
175. § 1.1001-3(e)(4)(vi)(A)(1).
176. § 1.1001-3(e)(4)(vi)(A)(2).
177. *See* I.R.C. §§ 61(a)(12), 1001(c) (2006); Treas. Reg. § 1.1001-3(b).
178. *See* Treas. Reg. §§ 1.1001-1(a) (as amended in 1996), 1.1001-3(a)-(b).
179. *See* I.R.C. § 356(c), (d)(2)(B).
180. Adjusted by any OID, market discount, or bond premium. *Cf.* § 358.

whether there had been a significant modification of the non-security debt instrument.[181] Because Acquiring was acquiring substantially all of Target's assets (and assuming there was no change in payment expectations), there would not be a significant modification of the debt instruments.[182] Therefore, the taxpayer would not recognize any gain or loss on the exchange and would continue with the same adjusted basis and issue price.[183]

As discussed in Part III.A, in Revenue Ruling 2004-78, the IRS determined that certain debt instruments would qualify as security instruments, and therefore, the exchange would qualify as a tax-free exchange pursuant to a reorganization.[184] As a result, the taxpayer would not recognize any gain or loss on the exchange.[185] In that Revenue Ruling, the taxpayer received two-year notes that the IRS ruled were security instruments because the notes given up in the exchange were security instruments and the terms of the note received were nearly identical to the terms of the note exchanged.[186] It is doubtful and unlikely that the debt instruments received would have otherwise constituted a security instrument because of the short-term nature of the debt instruments.

In that same Revenue Ruling, however, the IRS acknowledged that if the exchange had fallen outside of the reorganization provisions, the change in interest rate from the old debt instrument to the new debt instrument would have constituted a significant modification.[187] Therefore, had the tax-free reorganization provisions not applied to the exchange, the exchange would have been a taxable sale or exchange. If there had been a sale or exchange in Revenue Ruling 2004-78 because the debt instrument received had not been characterized as a security instrument, the taxpayer would have recognized gain or loss on the exchange equal to the difference between the issue price of the debt instrument he received and his adjusted basis in the debt instrument given up in the exchange.[188]

The main difference between taxable treatment outside of the tax-free reorganization provisions and partially tax-free treatment under the tax-free reorganization provisions is that in the context of a taxable sale or exchange, the taxpayer may recognize any losses he may have.[189] The amount of gain recognized by the taxpayer under the two different tax

181. *See supra* Part IV.A.
182. *See* Treas. Reg. § 1.1001-3(e)(4)(i)(C).
183. *See supra* notes 177-78 and accompanying text.
184. *See* Rev. Rul. 2004-78, 2004-31 I.R.B. 108, 109.
185. *See id.*
186. *See id.*; Treas. Reg. § 1.1001-3(e)(4).
187. *See* Rev. Rul. 2004-78, 2004-31 I.R.B. 108, 109.
188. *See* I.R.C. § 1001(c) (2006); Treas. Reg. § 1.1001-1(g) (as amended in 1996).
189. *Compare* I.R.C. § 165(a), *with* § 354(a).

treatments may also differ; which method is more advantageous to the taxpayer depends on the particular circumstances of the exchange.

If there is a significant modification of a debt instrument, then there is a taxable sale or exchange of the debt instrument. Thus, the holder will recognize gain or loss equal to the difference between the taxpayer's amount realized and his adjusted basis in the old debt instrument.[190] The holder's amount realized would be equal to the issue price of the new debt instrument.[191] If the debt instrument is not publicly traded, then the issue price will be equal to its stated principal amount.[192]

If the only modification to a debt instrument is a change in the obligor, as in a taxable exchange taking place in connection with a tax-free reorganization or merger, then under section 1001, there is no significant modification and therefore no sale, exchange, or other disposition for tax purposes.[193]

C. Using the Issue Price Versus Principal Amount in Tax-Free Reorganizations

To determine the amount of taxable gain in a tax-free reorganization, taxpayers are instructed to use the principal amount of the security instrument rather than the issue price of the security instrument.[194] The

190. *See* §§ 165(a), 1001(a), (c). The holder's adjusted basis in the old debt instrument will be what the holder paid for it, increased by any market discount the holder previously included in income, reduced by any amortizable bond premium previously allowed, and further reduced by any principal payments already made on the debt instrument. *See* §§ 1016, 1272(a), 1278(a). The holder's adjusted basis in the new debt instrument would be equal to his amount realized (the issue price of the new debt instrument). *See* § 1012.

191. *See* § 1001(b); Treas. Reg. § 1.1001-1(g).

192. *See* I.R.C. § 1274.

193. *See* Pinellas Ice & Cold Storage Co. v. Comm'r, 287 U.S. 462, 468-70 (1933); Treas. Reg. § 1.1001-3(e)(4)(i)(C) (as amended in 1996). If the exchange is pursuant to a tax-free reorganization where taxpayers exchanged stock for stock and also exchanged security instruments for new debt instruments in the same corporation that did not qualify as security instruments, the new debt instruments would be boot to the taxpayer. *See* I.R.C. § 356(a)(1). The holder of the security instrument will have taxable gain equal to the fair market value of the debt instrument. *See id.* The taxpayer's gain will be limited to the amount of gain realized in the reorganization. *See id.* Because the exchange would partially qualify under section 354, the taxpayer would not recognize any losses inherent in the exchange. *See* § 356(c).

194. *See* §§ 354(a)(2), 356(d)(2)(B). Using the principal amount of a security instrument rather than the issue price to determine the amount of taxable gain is incorrect and further exacerbates the problem by distorting the true economic gain or loss that a taxpayer may have. Using the principal amount of a security instrument does not reflect the true and actual economic amount of gain or loss that a taxpayer has; rather, it is an artificial number that can trigger gain unjustifiably to a taxpayer in a tax-free reorganization because the principal amount of a debt instrument does not reflect the adjusted basis of a debt instrument or the fair market value of a debt instrument. This inconsistency has been raised several times by commentators, but has never been corrected. Because the issue price of a security instrument is a more accurate representation of the security instrument's

principal amount of a debt instrument is generally equal to the amounts due under the note less any stated interest.[195]

While the principal amount of a newly received security instrument may exceed the principal amount of the old security instrument, which results in the taxpayer recognizing gain, the taxpayer may actually end up with less profit or true economic gain than the taxpayer is required to recognize. For example, if a taxpayer exchanges a security instrument in a corporation with a $1000 principal amount, a 10% interest rate, and a

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fair market value, using the excess of the issue price over the adjusted basis of the debt instrument rather than the excess principal amount when determining the gain a taxpayer has in a tax-free reorganization represents a more correct figure and is more representative of the taxpayer's economic gain. *See* Yaron Z. Reich, Jodi J. Schwartz & David M. Rievman, *Effect of OBRA '90 on Debt-for-Debt Exchanges*, 51 TAX NOTES 79, 83 (1991); Michael L. Schler, *NYSBA Sees Flaws in Treatment of Debt Securities Received in Corporate Reorgs.*, TAX NOTES TODAY, Feb. 15, 1995, 95 TNT 31-25 (LEXIS); *see also* Carolyn Joy Lee, *NYSBA Comments on Tax Provisions of President's Plan*, TAX NOTES TODAY, Dec. 28, 1995, 95 TNT 252-25 (LEXIS) (commenting that the same issue—principal amount versus issue price—arises in connection with an exchange of nonqualified preferred stock in a reorganization and stating that the "rule, literally applied, would create taxable gain whenever an appreciated debt security is surrendered for preferred stock with a value above the debt security's adjusted issue price, even if the debt and preferred have the same value. This would be particularly harsh if, for example, the new preferred and the old debt had substantially the same terms"). Because the rules enacted regarding nonqualified preferred stock instead treat nonqualified preferred stock as qualified preferred stock if it is exchanged for other nonqualified preferred stock with substantially identical terms, an exchange of nonqualified preferred stock will not encounter the same unfairness and inconsistent tax treatment as regular debt security instruments. *See* I.R.C. § 354(a)(2)(C); Treas. Reg. § 1.356-7(b). The flaw of using principal amount was also acknowledged by Congress in its proposed amendments to section 356 in 1991 although it was never rectified. *See* STAFF OF J. COMM. ON TAXATION, 102D CONG., TECHNICAL EXPLANATION OF THE TAX SIMPLIFICATION ACT OF 1991, at 80 (J. Comm. Print 1991) [hereinafter TECHNICAL EXPLANATIONS].

The reasoning behind defining nonqualified preferred stock as a separate type of interest in a corporation different from qualified preferred stock was that nonqualified preferred stock resembled debt. Therefore, one must wonder why, in 1997, Congress chose not to impose the same onerous gain recognition rules on nonqualified preferred stock. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1014, 111 Stat. 788, 919; J. COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 210 (J. Comm. Print 1997).

Tax legislation to change principal amount to issue price in sections 354 and 356 was raised in 1991 to make the reorganization provisions more consistent with the original issue discount provisions; however, this legislation was never enacted. *See* TECHNICAL EXPLANATIONS, *supra*, at 80.

Some commentators have tried to suggest that when Congress stated "principal amount" in the Code, it actually meant "issue price" because of the confusion it would otherwise create. *See* BARNET PHILLIPS, IV & ROBERT P. ROTHMAN, STRUCTURING CORPORATE ACQUISITIONS—TAX ASPECTS A-89 (3d ed. 2005). It is clear, however, that Congress views the two terms as separate and distinguishable. *See* § 312(a)(2) (guiding the taxpayer to use the principal amount of a debt instrument except where there is OID and then to use the aggregate issue price of the debt instrument).

195. *See* Treas. Reg. § 1.1274-2(b)(1) (as amended in 1996).

fair market value of $1200 for a security instrument with a $1200 principal amount, a 4% interest rate, and a fair market value of $1100 in the same corporation pursuant to a recapitalization, under the reorganization provisions, the taxpayer would have $183.33 of gain.[196] The taxpayer has taxable gain of $183.33 because the principal amount was higher in the security instrument received in the exchange than the principal amount of the security instrument given up in the exchange, even though the taxpayer really only has gain of $100 (the difference between his adjusted basis and the fair market value of what he received). In addition, the taxpayer has an economic loss of $100 because the fair market value of the security instrument that the taxpayer received is less than the fair market value of the security instrument the taxpayer gave up in the exchange. Despite the taxpayer's economic value loss on the exchange, the taxpayer must recognize gain because the Code uses the principal amount of a security instrument as the measuring factor to determine gain rather than the fair market value or the issue price of the security instrument.

If, alternatively, the tax-free reorganization provisions do not apply to an exchange, making the exchange fully taxable, then instead of using the principal amount, the relevant measurement to the determination is the issue price of the debt instrument under section 1001.[197] An exchange might be taxable, for example, if the debt instruments do not qualify as security instruments or because the exchange was not made in connection with a tax-free reorganization.[198]

The issue price of a debt instrument generally represents the fair market value of the instrument. Determining the issue price of a debt instrument depends on whether or not the note is publicly traded.[199] In general, in a publicly offered debt issuance, the issue price of a debt instrument is the price that the majority of buyers are willing to pay when

196. *See* Treas. Reg. § 1.356-3(c) ex. 5 (as amended in 2000). Assume that because of market conditions and the interest rates on the two security instruments that the fair market value of the security instrument given up in the exchange ($1200) was greater than the fair market value of the security instrument given up ($1100).

197. *See* § 1.1001-1(g).

198. *See supra* text accompanying notes 41-56.

199. *See* I.R.C. §§ 1273(b), 1274(a). A debt instrument is considered publicly traded if it is "traded on an established market." *See* § 1273(b)(3). A debt instrument is "traded on an established market" if (1) it is listed on certain security exchanges, interdealer quotation systems, or certain foreign exchanges or boards of trade; (2) it is traded on certain boards of trade that are "designated as a contract market . . . or on an interbank market"; (3) "it appears on a system of general circulation . . . that provides a reasonable basis to determine fair market value by disseminating either recent price quotations . . . of one or more identified brokers, dealers, or traders or actual prices . . . of recent sales transactions"; or (4) "price quotations are readily available from dealers, brokers, or traders" within the meaning of the applicable Treasury Regulations, and certain other conditions are met. Treas. Reg. § 1.1273-2(b), (f) (1994).

the corporation first offers the debt instrument for sale to the public.[200] If it is paid for in cash, the issue price will be equal to the cash value.[201] If the debt instrument is paid for in property and is publicly traded, then the issue price will be equal to the fair market value of the property.[202] If the debt instrument is not publicly traded, its issue price will generally be equal to its principal amount.[203]

The issue price of a debt instrument will be adjusted by adding or subtracting certain items to the issue price, creating the adjusted issue price.[204] Any OID will be added to the issue price.[205] Any payments that

200. *See* I.R.C. § 1273(b)(1).

201. *See* § 1273(b)(1)-(2).

202. *See* § 1273(b)(1)-(3). If a security instrument is exchanged for a new security instrument, and both the new and original security instruments are publicly traded, then the issue price of the new debt instruments is equal to the trading price of the old debt instruments at the first time the debt instruments are offered to the public. *See* Treas. Reg. § 1.1273-2(c)(1).

203. *See* I.R.C. § 1274(a).

204. *See* § 1272(a)(4); Treas. Reg. § 1.1275-1(b) (as amended in 2002).

205. *See* I.R.C. § 1272(a)(3)-(4); Treas. Reg. § 1.1275-1(b)(1)(i). OID is when a debt instrument's issue price is less than its stated redemption price at maturity. *See* I.R.C. § 1273(a)(1). The stated redemption price at maturity is the amount a holder will receive when the debt instrument reaches maturity and is redeemed. *See* § 1273(a)(1)-(2). As described above, a debt instrument's issue price is generally equal to the price that most buyers are willing to pay for a debt instrument the first time it is offered for sale to the public. *See* §§ 1273(a)(1)-(2), (b), 1274(a). When a debt instrument has OID, holders must include the amount of the discount into income throughout the term of the debt instrument as it accrues. *See* §§ 1272(a), 1273(a)(1)-(2). It is very similar to a phantom interest payment, and constitutes ordinary income to the holder. *See* §§ 61(a), 1273(a)(1)-(2). Assume again that a corporation issues a debt instrument with a $1000 principal amount and a 10% interest rate and, because of corporate issues, the amount the public is willing to buy the debt instruments for the first time they are offered to the public is $900. The issue price is therefore $900. Because this is the original issue of the debt instruments (the first time they are issued to the public), there is a $100 discount, so there is OID of $100. Here, the corporation will pay the full $1000 principal amount plus 10% interest to the taxpayer on maturity (when the debt instrument becomes due). If the taxpayer receives $100 more than he paid for the debt instrument, the $100 would be treated as interest along with the actual interest payment. However, under the OID provisions, the taxpayer will include the $100 OID in income throughout the term of the note rather than when the amount is actually paid. *See* §§ 61(a), 1273(a)(1)-(2). The payment is amortized and taxed as interest throughout the term of the debt instrument and is added to the adjusted issue price of the debt instrument. *See* § 1273(a)(1), (3).

Market discount occurs after the issue price of a debt instrument has been established and a taxpayer subsequently buys a debt instrument for less than its issue price. *See* § 1278(a). Using the earlier example, assume a corporation offers a debt instrument with a $1000 principal amount and a 10% interest rate. The issue price of the debt instrument is $900. Then, two years later, a taxpayer decides to buy one of the debt instruments that has previously been issued, but the corporation is less financially secure than it was previously. Therefore, the price the taxpayer is willing to pay for the debt instrument is $850. There is $100 of OID and $50 of market discount. Assuming that the corporation pays what it owes on the debt instrument, any amounts paid over $850 will be treated as ordinary income, have been made with regard to the debt instrument, excluding any interest payments, will be subtracted from the adjusted issue price. The adjusted issue price will also be reduced by any bond issuance premium amortized though the modification date.[206]

The most accurate amount to determine a taxpayer's gain in the reorganization provisions is the debt instrument's fair market value. It would be ideal to replace the principal amount in the calculation of gain with the fair market value of the debt instrument represented by the debt instrument's issue price. This would also be consistent with other uses of the debt instrument's issue price for items such as OID, market discount, and bond premium.

An increase in the principal amount in tax-free reorganizations of a security instrument represents an increase in the amount that a holder would be paid if the corporation liquidated. It is an increase in the underlying assets of the corporation, and the logic would follow that because a holder has a greater interest in these underlying assets, they should be taxed like a dividend. This taxation is not appropriate, how-

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just like interest. *See* §§ 1276(a), 1278(a). Even though the face amount of the debt is $1000, only $850 will be treated for tax purposes as principal, and the remaining market discount and original issue discount are treated as interest. Market discount is not considered interest for purposes of sections 354(a)(1) and 356(a)(2), and therefore, is not recognized on a debt-for-debt exchange that qualifies as a tax-free reorganization. *See* §§ 1276(a), (d)(1)(B), 1278(a). Instead, any market discount applicable to the old debt instruments is transferred to the new debt instruments. *See* §§ 1276(c)(2)(A), (d)(1)(B), 1278(a); *see also* JAMES S. EUSTICE, THE TAX REFORM ACT OF 1984 ¶ 3.03[5] (1984). Thus, in the context of an exchange of a security instrument for a new security instrument in a tax-free reorganization, if the taxpayer originally purchased the first security instrument with any market discount, that market discount is not altered at all, but rather will simply be passed on to the new security instrument, as though the security instrument was purchased with a market discount. *See* I.R.C. §§ 1276(c)(1)-(2), 1277(b)(2)(B), 1278(a)(1)(D)(iii).

206. *See* §§ 108(e)(3), 1272(a)(7); Treas. Reg. § 1.1275-1(b)(2). Bond premium or bond issuance premium is the opposite circumstance from market discount. Instead of paying less than the issue price for a debt instrument, if there is bond premium, then the taxpayer paid more for the debt instrument than the issue price of the debt instrument. Thus, the taxpayer has paid a "premium" for the debt instrument. *See* Treas. Reg. § 1.163-13(c) (as amended in 1999). This might occur, for example, if the interest rate is higher than the current rate offered on other debt instruments. For example, assume that a debt instrument has a principal amount and issue price of $1000 and an interest rate of 10%. The current interest rate being offered on debt instruments is 4%. Therefore, the taxpayer may be willing to pay more for the higher interest rate. If the taxpayer paid $1050 for the debt instrument, the taxpayer would have a $50 premium ($50 over the issue price). The taxpayer may then deduct the $50 over the term of the debt instrument. *See* I.R.C. § 1272(a)(7). If an exchange of a security instrument in a corporation for a new security instrument in the corporation qualifies under the reorganization provisions, and the holder has a bond premium on the old security instrument, the bond premium will be passed onto the new security instrument regardless of the new security instrument's issue price and will continue to be amortized over the term of the debt instrument if the taxpayer so elects. *See* §§ 1272(a)(7), 1278(a)(2).

ever, for several reasons. First, the taxpayer owns debt and has not, in fact, received a dividend. Although the taxpayer has received an additional principal amount on paper, the taxpayer has not received any additional cash. If the taxpayer actually receives the additional amounts of principal in the form of cash and the amount he receives is greater than the amount he paid for the debt instrument, he will have taxable gain. Until he actually receives these amounts and has "cashed out" his investment, however, the excess principal amount is only on paper. In addition, although the taxpayer has received an additional amount of principal, the security instrument he receives may not actually be worth any more than the security instrument he gave up in the exchange. Several factors go into what a debt instrument is worth, including the interest rate, the term, the market interest rate, and the credit condition of the corporation.[207] So, although the taxpayer receives an additional principal amount on paper, what he owns may actually be worth less. The additional principal amount may, for example, be given to the taxpayer to compensate him for such a loss of value. However, without a sale or exchange, the taxpayer has not cashed out his interest and therefore should not be taxed until he does.

V. THE TAX TREATMENT OF SECURITY HOLDERS CREATES UNFAIR AND INCONSISTENT TAX CONSEQUENCES

The tax treatment of holders of security instruments is inconsistent, inequitable, and unnecessarily confusing for several reasons. Applying the continuity of interest doctrine to security instruments is inappropriate and complicates the tax treatment of holders of security instruments. The tax treatment of holders of non-security debt instruments is currently more advantageous in tax-free reorganizations than the tax treatment of holders of security instruments, even though a heightened ownership interest and continuity of interest requirement applies to holders of security instruments. This tax treatment produces results that are against public policy and are inconsistent with the policy motivations of Congress. Therefore, the tax treatment of holders of security instruments should be corrected, and they should be afforded the same tax treatment as holders of non-security debt instruments.

A. Treating Security Instruments as a Hybrid Interest Between Debt and Equity and Requiring Continuity of Interest is Confusing and Inconsistent

Requiring holders of security instruments to meet a continuity of interest requirement is inconsistent with the current reorganization provisions. The continuity of interest requirements, as included in the definition of

207. *See* § 1273; Land, *supra* note 28, at 62.

security instruments or the criteria of security instruments, is a misinterpretation of *Pinellas*.[208] The continuity of interest requirement was intended to be applied to stockholders to meet the requirements of a reorganization.[209] It is not clear that the continuity of interest doctrine was ever intended to be applied to holders of security instruments to determine if the ownership interests qualified as security instruments.

There is a certain futility in requiring security holders to hold a continuing interest in a corporation because it is impossible to determine a holder's motives for owning a debt instrument. Because debt instruments are generally freely transferable and tradable, rarely will a holder actually have a motive to maintain a continuing interest in a corporation. In addition, such a requirement is inconsistent with the current direction of the continuity of interest doctrine based on the recent revisions to those provisions.[210]

The continuity of interest requirement, as applied to stockholders, has been narrowed in recent years. For example, the continuity of interest doctrine no longer requires that stockholders retain their interests following a reorganization.[211] Rather, the relevant period to test stockholders is prior to, and immediately after, the transaction. As long as there was no prearranged plan to sell shares prior to the reorganization, the stockholders are free to sell their shares immediately after the transaction without any effect on the continuity of interest requirement.[212] Therefore, generally, as long as the stockholders exchange their target shares for acquiring stock in the exchange, even if the stockholders choose to sell their stock afterward, the transaction will not affect the reorganization from qualifying as tax free.[213]

Because a stockholder may not hold the stock with the intention of holding a long-term investment in the corporation, the reality is that the individual motive of the stockholder is irrelevant. If the individual motives of stockholders are irrelevant to the continuity of interest require-

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208. *See* Griswold, *supra* note 55, at 708-09.

209. *Id.* at 707-09.

210. In the legislative history to like-kind exchanges, the Senate Finance Committee stated in 1924, "[t]he intention of the party at the time of the exchange [i.e., why they are holding the property] is difficult to determine, is subject to change by him, and does not represent a fair basis of determining tax liability." S. REP. NO. 68-398, at 14 (1924).

Ironically, although holders of security instruments are currently held to this continuity of interest requirement, the continuing interest of a security holder does not count toward the continuity of interest requirement in the reorganization provisions. *See* Treas. Reg. § 1.368-1(e) (as amended in 2005); BITTKER & EUSTICE, *supra* note 43, ¶ 12.21[9].

211. *See* Treas. Reg. § 1.368-1(e)(7) ex. 3. The example assumes that there was not a pre-arranged plan to sell off the target shares or acquiring shares immediately after the reorganization. *Id.*

212. *See* § 1.368-1(e).

213. *See* § 1.368-1(e)(7) ex. 3.

ment in reorganizations, the question then becomes why the intent of debt holders is relevant to the continuity of interest test. By requiring security holders to represent an enhanced degree of participation in the corporation and to represent a continuing interest in the corporation beyond that of a debt holder, the continuity of interest doctrine, as applied to security holders as created by case law, is more rigorous than the continuity of interest requirement as applied to stockholders under the reorganization provisions.[214]

The requirement that holders of security instruments maintain a continuing interest in the corporation is inconsistent with the current continuity of interest requirements imposed on reorganizations, particularly because stockholders are no longer required to maintain a continuing interest after the reorganization.

Another example of how the continuity of interest requirement has eroded and further diminished as applied to stockholders is that there is no continuity of interest requirement in E and F reorganizations for stockholders.[215] The reasoning behind not requiring a continuity of interest requirement in an E or F reorganization is that because of the very nature of the type of reorganization, such a requirement for the stockholders is not necessary.[216] If, however, debt instruments are exchanged for debt instruments in a recapitalization qualifying as an E reorganization, to qualify as security instruments and therefore for tax-free treatment, the security instruments must represent a continuing interest in the corporation, even though a continuity of interest requirement will not be imposed on the equity holders in the corporation. Once again, the continuity of interest requirement is more rigorous to security holders than it is to stockholders (or in this case as it is non-existent for stockholders). A greater investment motive is required of holders of security instruments, which represent a hybrid of debt and equity, than is required of stock, which is pure equity.

There is no logical reason to require security holders to have a continuing interest in the corporation, particularly when the same requirement is not made of stockholders. The continuity of interest requirement as applied to security instruments is an arbitrary rule used to make the determination of whether debt instruments will constitute security instruments. Because security instruments are debt, they cannot meet the characteristics of equity as stock does. By the very nature of debt, the holders of security instruments wish to be repaid whether the corporation is in good or poor financial health. Holders of debt instruments do not have a financial interest in the corporation beyond being paid on their

214. *See* Comm'r v. Freund, 98 F.2d 201, 206-07 (3d Cir. 1938).
215. *See* Treas. Reg. § 1.368-1(b).
216. *See* Hickok v. Comm'r, 32 T.C. 80, 89 (1959).

debt instruments. Alternatively, stockholders by their very nature have a vested interest in seeing the corporation grow and succeed to maximize their investment.

Requiring stockholders and holders of security instruments to have similar motivations and interests in the corporation belies the very nature of the underlying investments. Holders of security instruments hold debt, not stock, and therefore, the reorganization requirement for continuity of interest in the corporation should not apply to holders of security instruments as though they hold a form of equity.

The correct test for security instruments is not whether holders have a continuing interest in the corporation, but instead, whether the debt instrument represents an *investment* in the corporation, as opposed to a *loan* to the corporation as a creditor. The determination must be whether the security instrument represents debt instead of equity rather than trying to create a hybrid category somewhere between debt or equity only for security instruments.[217] If the holders have an investment in the corporation which is more like stock or equity, then an exchange of security instruments should be entitled to fully tax-free treatment, just like stock. If, however, the investment that holders must have to be classified as security holders is more like debt, then an exchange of security instruments should be fully taxable and subject to the debt modification rules under section 1001—just like any other sale or exchange involving debt instruments. Presumably all, if not most, security instruments fall into the debt category rather than the equity category and therefore are subject to sale or exchange analysis under section 1001.

The ideal solution would be to acknowledge that security holders do not hold the same interest as stockholders and are not entitled to the same preferences of equity ownership in a corporation. As a result, they should not be treated as having, or be required to have, the same motivations and intentions as a stockholder. Rather, the reorganization provisions should contemplate and acknowledge that security holders hold debt instruments. Thus, the tax consequences of an exchange of debt instruments in a reorganization should reflect the nature of their investment.

It is true that there is a difference between security instruments and non-security instruments. In general, security instruments represent a long-term interest in the corporation.[218] Security holders have made a longer commitment to the corporation than holders of short-term debt instruments. This difference, however, is not sufficient to justify the dif-

217. The debt-versus-equity debate is challenging enough without the inclusion of an unnecessary and unclear hybrid category in the middle. *See generally* BITTKER & EUSTICE, *supra* note 43, ¶ 4.02; Polito, *supra* note 43, at 777-79.

218. *See supra* notes 44-47 and accompanying text.

ference in the tax treatment between the two types of interests. The interests are sufficiently alike that they should be taxed in the same manner. Both are debt instruments, not equity interests. In either case, both are creditors of the corporation with a higher priority than holders of equity and a fixed return. Neither type of interest participates in the growth of the company to a significant extent. While holders of security instruments do have an enhanced participation in the corporation, it does not rise to the level of the participation that equity holders have. Because the superior participation rights in the corporation are insufficient to change the interest from debt to equity, they are also insufficient to justify taxing security interests differently than short-term debt. If the participation rights were sufficient enough to justify the different tax treatment, then the security instruments should be reclassified as equity. Creating the third hybrid class of security instruments, which falls between debt and equity based on the elevated participation rights of security holders, creates too much confusion and unnecessary complication.

In an attempt to simplify the tax system, taxpayers should be allowed the luxury of being able to determine what they own, and to understand the tax consequences that arise as a result of their ownership interest in the corporation. Because of the current structure of the taxing regime as applied to security instruments, often taxpayers cannot determine what they own and therefore cannot properly ascertain their tax consequences.

If, however, Congress ultimately determines that there is still a need for maintaining this middle hybrid category between debt and equity for security instruments, a bright line rule should be established. The current system of evaluating certain factors and trying to pin down whether a security instrument represents a continuing interest in the corporation can often yield inconsistent and unfair results. A time-test can also often come up with arbitrary results. For example, a debt instrument with a term of nine years and ten months is not a security instrument, but a debt instrument with a term of ten years is a debt instrument. A bright line test, however, does give easy, clear rules, and such a mechanical determination should be applied to afford taxpayers the ability to determine clearly what they own. To use prior case law as a basis, if a mechanical time test were chosen, perhaps a ten-year test would be appropriate.[219] If a debt instrument had a term of ten years or more, it would be considered a security instrument; conversely, if it had a term of less than ten years, it would not be a security instrument. This approach of allowing a middle hybrid category would not, however, resolve the critical issue that non-security debt holders often have better tax consequences than the tax consequences afforded to security holders.

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219. *See generally supra* note 51 and accompanying text.

Non-security debt holders have more advantageous tax treatment than holders of security instruments in a reorganization.[220] This is despite the fact that holders of security instruments are held to an elevated ownership interest, one that is a hybrid between debt and equity. The tax treatment of holders of security instruments, however, is worse than the tax treatment of both stockholders and holders of non-security debt instruments. In a tax-free reorganization, holders of security instruments must still recognize any gain on the fair market value of the excess principal amount of the security instrument that they receive in the exchange.[221] Therefore, unlike the tax-free treatment afforded to stockholders in tax-free reorganizations, holders of security instruments must still recognize gain on an exchange pursuant to a tax-free reorganization. Holders of non-security debt instruments must also recognize any inherent gain on an exchange in a tax-free reorganization.[222] The amount of gain that holders of non-security debt instruments must recognize is not limited to the fair market value of the excess principal amount in the exchange as it is in the case of security instruments. Holders of non-security debt instruments are taxed on the difference between their adjusted basis in the debt instrument given up in the exchange and the issue price of the debt instrument that they receive in the exchange.[223] While in some cases the holders of non-security debt instruments may recognize more gain than holders of security instruments, this is not necessarily always the case.

If, for example, the excess principal amount of the security instrument exchanged is greater than the difference in fair market value, a taxpayer would recognize more gain through a tax-free reorganization than through a taxable exchange. If taxpayer C exchanges a security instrument with an adjusted basis and principal amount of $1000 for a security instrument with a principal amount of $1200 and a fair market value of $1080, the security holder would recognize gain equal to the fair market value of the excess principal amount or $180.[224] If the exchange had been fully taxable, the taxpayer would have only recognized $80 in gain.[225] The fair market value of a debt instrument might be less than the fair market value of the excess principal amount if, for example, the term of the debt instrument has been extended, or if the interest rate offered on the debt instrument is below the current market rate being offered on similar debt instruments.

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220. *See supra* notes 16-18 and accompanying text.

221. *See* I.R.C. §§ 354(a)(1)-(2), 356(a), (d)(2)(B) (2006).

222. *See* §§ 61(a)(4), 1001(a); *see also supra* notes 16-17 and accompanying text.

223. *See* I.R.C. §§ 1001(a), 1273(a), 1274; Treas. Reg. § 1.1001-1(g) (as amended in 1996).

224. Treas. Reg. § 1.356-3(c) ex. 5 (as amended in 2000).

225. *See* I.R.C. § 1001(a); Treas. Reg. § 1.1001-3 (as amended in 1996).

Short-term debt holders have a more advantageous tax position than the security holder, despite the fact that the security holder has more of an equity-type investment in the corporation and is therefore included in the tax-free reorganization provisions. Because most taxpayers would like to take advantage of losses, holding non-security debt instruments is a better choice for an investment than longer-term security instruments because of the favorable tax consequences.

It should also be noted that while a holder of a security instrument must recognize gain and cannot recognize loss on the exchange, in a tax-free reorganization, it is entirely possible that the holder of a non-security debt instrument will not have a taxable sale or exchange under section 1001.[226] Because in connection with many tax-free reorganizations there is no change in obligors—either because the same corporation is exchanging its own debt instruments or because the new obligor is acquiring substantially all of the old obligor's assets—there will not be a significant modification, and therefore no sale or exchange.[227] This would mean that the holder of a non-security debt instrument would not have a sale or exchange at all and would have similar, if not identical, tax consequences to stockholders in the same tax-free reorganization.[228] The security holders would, however, have taxable gain on the fair market value of any excess principal amount, even if they did not receive anything of any greater value. Once again, the most unfavorable tax consequences would fall to the holders of security instruments.

By favoring non-security debt instruments, which are generally short-term investments that do not represent a continuing interest in the corporation, the IRS is effectively discouraging investing in corporations through long-term debt instruments. In addition, for corporations that do have outstanding security instruments, restructuring these debt instruments is more difficult if the corporation tries to avoid the negative tax consequences for the holders of security instruments. The tax consequences awaiting holders of security instruments can also be a surprise to those structuring or restructuring the capital structure of the corporation because the transaction is characterized as tax free.

226. This is because a sale or exchange of a debt instrument requires a significant modification. *See* Treas. Reg. § 1.1001-3(e).

227. *See* § 1.1001-3(e)(4)(C).

228. Again, this is assuming that, pursuant to the reorganization, the taxpayer is not also exchanging stock or securities. If that were the case, all of the loss would be precluded. *See* I.R.C. § 356(c).

B. The Tax Treatment of Security Instruments in Tax-Free Reorganizations Is Inconsistent with Public Policy

Congress enacted the reorganization provisions to avoid taxing transactions that took place simply on paper.[229] In the case of security instruments, the Code now taxes a mere exchange of one security instrument for another with the justification that the security holder is receiving something of greater value for his interest.[230] The taxpayer, however, is precluded from recognizing a loss when he receives something of lesser value.[231] By changing the rules to provide that an exchange of security instruments is fully taxable, Congress would actually be encouraging longer-term investment in corporations because the tax treatment would be just as favorable as that applicable to non-security debt instruments.

In addition to discouraging investors from investing in long-term security instruments (and encouraging investing in short-term notes instead), the current tax provisions also encourage security holders to sell their security instruments entirely rather than exchange them in a tax-free reorganization. Because security holders cannot recognize losses and must recognize gains, in a tax-free reorganization it is to security holders' advantage to sell their security instrument for cash rather than to exchange it for a new security instrument, which could give rise to unfavorable tax consequences.[232]

This result runs contrary to the idea that by stimulating investment in corporations, the Code will stimulate the economy. This system encourages selling security instruments rather than exchanging them for new security instruments and maintaining long-term investment in the corporate form. The tax treatment of holders of security instruments in tax-free reorganizations also conflicts with the policy that taxpayers should invest in long-term investments. This is contrary to the repeated commitment by Congress to encourage long-term investments in corporations. It encourages consumption, or the buying and selling of investment interests rather than investing for the long-term, because taxpayers are better off either holding a shorter-term, non-security debt instrument or selling off their security instrument should a tax-free reorganization arise, than maintaining their current investment in the corporation.[233] The pro-

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229. *See* S. REP. NO. 65-617, at 5 (1918).

230. *See* I.R.C. § 354(a)(1)-(2).

231. *See* § 354(a)(1).

232. *See* § 354(a)(1)-(2). This assumes that the new debt instrument would be for a different face amount than the old debt instrument.

233. Fully taxing the exchange of security instruments in a tax-free reorganization is inconsistent with a consumption tax. Proponents of the consumption tax would argue that because the taxpayer has not cashed out his investment, there should not be any tax consequences to the exchange of the security instruments because the taxpayer is maintaining his investment. *See generally* William D. Andrews, *A Consumption-Type or Cash Flow*

visions convert what would have been a purely paper transaction, which Congress expressed a desire to avoid taxing, into a taxable transaction.

The tax treatment of security instruments otherwise conflicts with the policy motivations behind the reorganization provisions. One of the justifications given for creating and keeping the reorganization provisions is that there should be tax-free treatment until an investor cashes out his interest.[234] Because the taxpayer may not have cash available in an exchange of stock or security instruments until there is actually a cash sale, taxing the gain prior to the cash sale would require investors to sell their underlying interests to pay for the tax. In the case of security instruments, security holders do not have any additional cash as a result of a tax-free reorganization. Yet, holders of security instruments must pay tax on any gain inherent in the exchange at the time of the exchange.[235] This differs from stockholders who may have inherent gain as the result of an exchange in connection with a tax-free reorganization, but will not be taxed on that gain until the stockholders cash out their investment because of the tax-free nature of the transaction.[236] By requiring that security holders pay tax on the gain prior to receiving any cash proceeds from their investment, holders of security instruments are in a position where they may have to sell their security instruments to pay the tax on the inherent gain. Furthermore, because the tax treatment pursuant to a fully taxable exchange is more beneficial to holders of security instruments, they are better off simply selling their security instruments should a tax-free reorganization arise rather than participating in the exchange.

C. Legislative History Dictates that the Tax Treatment of Security Instruments in Reorganizations Should Be Changed

Congress had a dual motive in enacting both the reorganization provisions and the rules relating to the taxation of security instruments in tax-free reorganizations. Initially, Congress wanted to avoid taxing transactions that were purely on paper—where the taxpayer never actually cashed out his investment.[237] Additionally, Congress wanted to maintain

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Personal Income Tax, 87 HARV. L. REV. 1113, 1148-53 (1974). Even under a consumption tax regime, however, the current tax treatment of an exchange of security instruments in a tax-free reorganization is not correct. Rather, true tax-free treatment would be consistent with the consumption tax. One could argue whether or not our current income tax system should be restructured as a consumption tax instead. That, however, is beyond the scope of this Article. What can be assured is that under our current tax system or even under a consumption tax, the current taxation of an exchange of security instruments in a tax-free reorganization is inconsistent and unfair to taxpayers, and it should be noted that the taxpayer would benefit economically under either scenario.

234. *See* Brauner, *supra* note 92, at 53-56; *see also* S. REP. NO. 67-275, at 11-12 (1921).

235. *See* § 354(a)(1)-(2).

236. *See supra* notes 91-94 and accompanying text.

237. *See* S. REP. NO. 67-275, at 11-12.

the reorganization provisions to ensure that taxpayers could not take losses, particularly at a time when the United States economy and the United States Treasury were hurting financially.[238]

According to the legislative history, Congress thought the reorganization provisions allowed the taxpayer to avoid recognizing gain on "paper transactions" or where they had not yet actually converted their ownership interests to cash.[239] The Senate stated that requiring taxpayers to recognize gain severely interfered with necessary business adjustments.[240] The Senate also stated that the reorganization provisions would considerably "increase the revenue by preventing taxpayers from taking colorable losses in wash sales and other fictitious exchanges."[241] Extensive rules written and incorporated into the Code since that time have been enacted and address the possibility that taxpayers could engage in fictitious exchanges to trigger losses.[242]

It is not clear that the concern of Congress is legitimate—that making an exchange of security instruments in a tax-free reorganization a fully taxable event would allow taxpayers to take losses from fictitious exchanges. The economic conditions have changed since the days these provisions were enacted. Taxpayers could orchestrate such fictitious exchanges under the current reorganization provisions if they wished. Allowing taxpayers fully taxable treatment on an exchange of security instruments in a tax-free reorganization would not start a spate of fictitious exchanges to trigger losses. In particular, it is stockholders, not security holders, who have a vote in corporate affairs. In addition, with or without the reorganization provisions, sales or exchanges can be deliberately triggered by those choosing to manipulate the tax system. The question being addressed is what happens to those long-term investors who do not have any actual economic gain on an exchange of security instruments and must now recognize gain but cannot recognize loss.

The House of Representatives stated that an attempt to prevent fictitious exchanges was not a sufficient reason to justify the reorganization provisions; although the reorganization provisions did make it more difficult to take losses, it did not make it impossible.[243] Rather, a House subcommittee created to investigate tax avoidance indicated that all that would be required if someone were so inclined would be to simply restructure a transaction so that it did not fall into the reorganization provi-

238. *See* H.R. REP. NO. 73-704, at 9-10 (1934).
239. *See* S. REP. NO. 67-275, at 11-12; S. REP. NO. 65-617, at 5-6 (1918).
240. *See* S. REP. NO. 67-275, at 11.
241. *Id.* at 11-12.
242. *See, e.g.*, I.R.C. §§ 267, 1091 (2006); *see also* Deputy v. du Pont, 308 U.S. 488, 496-98 (1940).
243. *See* H.R. REP. NO. 73-704, at 13.

sions.[244] Again, it would be difficult for security holders to deliberately structure such a transaction because they have no vote in the corporation.

It was in 1934, in the midst of the Great Depression, that the possibility of removing the reorganization provisions from the Code was raised.[245] It was ultimately dismissed because many people had losses in their stock at that time and the United States Treasury simply could not afford the loss of tax revenues if taxpayers could recognize these losses.[246] The Great Depression is over, and tax simplification, consistency, and encouragement of long-term investment in corporations must trump the fear of triggering losses, particularly since the Code requires holders of security instruments to recognize gain on the exchange of security instruments.

D. Solutions

There are two possible solutions to correct the inconsistent and unfair tax treatment of security instruments in corporate reorganizations. The first is that security instruments could be included with stock in the tax-free treatment of tax-free reorganizations. The tax treatment of the security instruments could mirror or parallel the tax treatment of stock. The second, more preferable and consistent solution is to treat security instruments in the same manner that non-security debt holders are treated for tax purposes.

1. Include Security Instruments in Tax-Free Reorganization Provisions with the Same Tax Treatment Afforded to Stock

While including security instruments with stock in the tax-free reorganization provisions would address some of the inconsistencies and inequities of the current tax treatment of holders of security instruments, it would still raise several issues and problems. Allowing security holders the same tax treatment as stock in tax-free reorganizations would, however, elevate the tax treatment of security holders above that of holders

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244. SUBCOMM. OF THE H. COMM. ON WAYS & MEANS, 73RD CONG., PRELIMINARY REPORT ON PREVENTION OF TAX AVOIDANCE 8-9 (H. Comm. Print 1933). The subcommittee noted, "[i]f a taxpayer desires to take a loss, it is easy to arrange a transaction falling without the [recognition of gain] exceptions." *Id.* at 39 (quoting a memorandum from the staff of the Joint Committee on Internal Revenue Taxation). Interestingly, the Ways and Means Committee determined that under the current climate (the Great Depression), most reorganizations prevented losses from being recognized rather than avoiding gains from being recognized; thus, the committee would not recommend removing the reorganization provisions. *See* H.R. REP. NO. 73-704, at 12-13. The current economic climate is, however, not the same as it was in 1934, and if the provision is truly a revenue raising provisions it is likely that the reorganization provision today results in gains not being recognized rather than raising revenue by precluding losses.

245. *See* H.R. REP. NO. 73-704, at 12.

246. *See id.* at 14.

of non-security debt instruments, which would justify requiring security instruments to have this hybrid-type interest between debt and equity.[247]

Affording security instruments tax-free treatment in tax-free reorganizations raises several issues. One problem this solution would not address is that it is still difficult to define a security instrument under the Code. This solution would not resolve this, and with the more favorable tax treatment of pure tax-free treatment, it is possible that more corporations or taxpayers might try to design debt instruments to look like security instruments to afford tax-free treatment while still retaining the advantages of a debt instrument. This could make the determination of whether a debt instrument is a security instrument even more difficult than it is currently because of the economic incentive that would suddenly be tied to classifying an interest as a security instrument.

A second problem is that security instruments are, in fact, debt instruments, although they have some equity characteristics. They are not equity despite the attempts by Congress and the courts to apply equity-like characteristics to them. Allowing holders of stock tax-free treatment and allowing holders of security instruments modified tax-free treatment encourages investment in equity-like interests. By affording the same treatment to security instruments, security holders could have all of the tax benefits of holding an equity interest without the burdens and risks of holding stock. Instead, they would have the greater sense of security that is afforded to debt instruments.

The determination of whether an interest was debt or equity would be not quite as critical if security instruments were afforded the same tax treatment as stock because holders of both types of interests would expect the same type of beneficial tax consequences.

Ultimately, however, allowing security instruments to have the same tax-free treatment that stock enjoys is not consistent with the policy motivations behind the reorganization provisions. Because security instruments are, in fact, debt instruments, by allowing the same tax treatment that is afforded to stock, the provisions would discourage stock owner-

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247. This approach would be consistent with not only the current tax treatment of stock in tax-free reorganizations but also with tax treatment in like-kind exchanges under section 1031. *See* I.R.C. § 1031. Both provisions were originally enacted in the same provision, former section 202(c). *See* I.R.C. § 202(c) (1924). The policy reasons behind the enactment were that until a taxpayer cashed out his investment, he should not pay tax on the gain.

Ironically, in contrast to the current attempt by the courts and Congress to discover or impute an intention on the part of holders of security instruments to maintain a continuing interest in the corporation, in connection with like-kind exchanges, the Senate Finance Committee found that a taxpayer's reason for holding the property did not serve as a proper measure for assessing tax liability. *See* S. REP. NO. 68-398, at 14 (1924). In 1921, Congress amended the reorganization provision (former section 202(c)) to also include like-kind exchanges. *See* S. REP. NO. 67-275, at 11 (1921).

ship. Debt is a more secure type of interest than stock because upon liquidation of a corporation, debt holders are paid before equity holders.[248] Therefore, if both security holders and stockholders were entitled to the same tax treatment, given a choice, an investor might opt for the security instrument and enjoy more safety for his investment while also having the more advantageous tax treatment.

The reorganization provisions were enacted to avoid taxing the conversion of one type of equity interest to another, and to avoid taxing an interest before it had ultimately been converted to cash.[249] If the option of affording security holders the same tax treatment was chosen, one would have to hope that at the very least, Congress would adopt a consistent and clear definition of a security instrument so that taxpayers could more clearly understand what type of investment they own. Security instruments are not equity and therefore should not be treated as such. Rather, security instruments are debt, and in the goal of simplifying the tax system, it would be ideal if the tax consequences of debt in a tax-free reorganization could be predictable and relatively uncomplicated to determine.

2. Tax Security Instruments as Non-Security Debt Instruments Are Taxed

The second alternative is to treat holders of security instruments in tax-free reorganizations in exactly the same manner that non-security debt holders are treated. Rather than distinguishing between security instruments and non-security debt instruments, all debt instruments would be treated alike. Under this proposal, an exchange of security instruments in a tax-free reorganization would be fully taxable subject to the sale or exchange rules under section 1001. This might result in many holders of security instruments recognizing more gain than they would have recognized under the current rules, depending on the economic circumstances of the exchange. It would, however, allow holders of security instruments to recognize losses in the same manner that non-security debt holders are able to recognize losses in a tax-free reorganization. Treating holders of security instruments in the same manner as holders of non-security debt instruments would also render irrelevant the mystery of whether a debt instrument qualified as a security instrument. Not having to make the determination of whether a debt instrument qualified as a security instrument would go a long way toward simplifying the reorganization provisions.

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248. *See, e.g.*, Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 902 (2003).

249. *See* S. REP. NO. 67-275, at 11-12.

An exchange of security instruments in a tax-free reorganization would be treated in the same manner as an exchange of security instruments in a taxable exchange. If there is a significant modification of the security instrument under section 1001, there will be a taxable exchange and the security holder will have taxable gain or loss. If there is not a significant modification of a debt instrument, the holder will not have taxable gain or loss. As noted earlier, a merger or reorganization where Acquiring Corporation acquired substantially all of the assets of Target Corporation will not amount to a change in the obligor and will not, therefore, be a significant modification.[250] As a result, the reorganization or merger itself will not cause a security holder to have taxable gain or loss. The security holder will recognize gain or loss if what he receives in the exchange differs in economic value from what he originally owned. Taxable gain would depend on whether the security holder was, in fact, richer than he was before the reorganization. Once again, this tax treatment would bring consistency and logic to the tax treatment of debt instruments under the reorganization provisions. All debt instruments would be taxed the same, without arbitrary distinctions governing or determining the tax treatment.

This solution would also be consistent with the basic principles of debt versus equity. Equity is not the same as debt, and maintaining an equity interest in a corporation is consistent with continuity of interest treatment where holders are maintaining their ownership interests in the corporation. Along with simplifying the reorganization provisions by dismissing the necessity for the definition of security instruments and making the tax treatment clearer, this approach would also clarify other issues relevant to the tax treatment of security and debt instruments.

Rather than using the principal amount of the security instruments as the measurement for gain, consistent with straight taxable exchanges of debt instruments, the issue price of the debt instruments would be used. This would alleviate a great deal of confusion for taxpayers on the amount of their taxable gain, as well as confusion regarding items such as OID, market discount, and bond premium.

The issue price of a debt instrument is a more accurate measurement of the fair market value and the true economic value of what a security holder is receiving versus giving up in the exchange. The principal amount can often have no relation to the economic value of the security instrument. Because items such as the term of the debt instrument, the interest rate, the financial strength and security of the corporation, any property securing the debt instrument, and many other items affect the fair market value of a security instrument, the issue price will reflect adjustments in the fair market value for any of these items. Therefore, the

250. *See* Treas. Reg. § 1.1001-3(e)(4)(C) (as amended in 1996).

issue price of the debt instrument will represent the true value of the debt instrument.

VI. ARGUMENTS IN FAVOR OF KEEPING THE CURRENT TAX STRUCTURE

Proponents of keeping the current tax treatment of holders of security instruments could argue that security holders are still in a more advantageous tax position than regular debt holders. Security holders do not have to recognize their total gain in a tax-free reorganization; rather, security holders must only recognize gain equal to the excess principal amount of the debt instruments they receive.[251] While it is true that security holders on an exchange in a reorganization must recognize any gain between the fair market value of the principal amounts of their debt instruments, because these numbers have no relation to the taxpayer's adjusted basis in the debt instruments, the taxpayer is still able to defer at least some recognition of gain. For example, assume that a taxpayer paid $60 for a debt instrument with a principal amount of $80 and an interest rate of 6%. In an exchange pursuant to a tax-free reorganization, the taxpayer exchanges the security instrument for a new security instrument with a principal amount of $80, an interest rate of 4%, and a fair market value of $80. The taxpayer would actually have $20 of economic gain, but under the reorganization provisions as currently drafted, the taxpayer would not have to recognize the additional realized gain of the difference between the fair market value of what he received in the exchange less his adjusted basis in the security instrument of $20.[252] Alternatively, if the two debt instruments were not securities, a holder of a non-security debt instrument would have to recognize the full $20 of gain on the exchange. An exchange like this example might occur if a corporation wanted to recapitalize because of poor financial conditions in the corporation. If the term on the debt instruments was coming due and the corporation could not pay the debt instruments, the corporation might offer security holders new security instruments with a greater fair market value in exchange for agreeing not to throw the corporation into bankruptcy.

In the example above, the taxpayer actually recognizes economic gain but avoids paying tax on it because of the reorganization provisions. If, however, as noted earlier, Congress was concerned about fictitious exchanges and colorable losses, then avoiding gain using these arbitrary figures is inconsistent with that concern. Rather, a taxpayer should pay tax on his true economic gain whether or not that ends up being less or more than the fair market value of the excess principal amount. In addi-

251. *See* I.R.C. § 354(a)(2)(A).
252. *See supra* notes 44-47 and accompanying text.

tion, because security holders cannot recognize loss, they are at a disadvantage when compared to non-security holders.

VII. CONCLUSION

Congress has repeatedly advocated for long-term investments in corporations over short-term investments. This position is illustrated by the tax-free reorganization provisions and other tax provisions such as the special long-term capital gains rate.[253] Congress also has shown a preference to equity ownership over debt ownership, which is illustrated by the reorganization provisions and the reduced dividend tax rates among other provisions. Some may argue that by allowing taxpayers to invest their money in corporations and leaving it there as long as possible, it stimulates economic growth and industry.

Unfortunately, however, the current tax treatment of holders of security instruments conflicts with the public policy of encouraging long-term investment. Debt holders are in a more favorable tax position if they hold short-term non-security debt instruments rather than long-term security instruments in the case of tax-free reorganizations. In addition to the fact that the tax treatment of short-term debt holders is often more favorable, long-term security holders will also have better tax consequences if, instead of participating in a tax-free reorganization, they sell their debt instruments outright and divest themselves of an interest in the corporation.

The reorganization provisions were originally enacted to avoid taxing taxpayers on paper gains, to avoid interfering with normal business adjustments, and to avoid forcing taxpayers to recognize gain before they had converted their ownership interests into cash.[254] Through modifications to the tax-free reorganization provisions, however, the tax treatment of security instruments conflicts with these legislative policies and directly conflicts with the legislative intent behind the provisions. Although an exchange of security instruments will be a paper transaction, security holders are taxed on gain and prevented from recognizing losses.[255] By causing the tax treatment of security holders in a tax-free reorganization to be unfavorable as compared to non-security debt holders in many scenarios, Congress is interfering with normal business adjustments. Business adjustments may be restructured to avoid these tax implications to security holders; debt holders may opt to purchase short-term investments rather than long-term investments to avoid the unfavorable tax consequences altogether, or rather than participate in the

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253. *See, e.g.*, Treas. Reg. § 1.904(b)-1(c)(ii) (as amended in 2004).

254. *See* S. REP. NO. 67-275, at 11-12 (1921); H.R. REP. NO. 65-1037, at 44-45 (1919); S. REP. NO. 65-617, at 5-6 (1918).

255. *See* I.R.C. §§ 354(a)(2), 356(d)(2)(B).

exchange at all, security holders may simply sell their security instrument outright to guarantee more favorable tax treatment. Security holders are also forced to pay tax on gain before they have ultimately converted their interests to cash. In addition, the amount of taxable gain that security holders are required to recognize does not accurately reflect their true economic gain. Rather, it is entirely possible that a taxpayer may, in fact, have an economic loss but because of the measurement of principal amounts that the reorganization provisions use to determine gain, even with an economic loss, the taxpayer may actually have to pay tax on a gain.

The taxation of security instruments in tax-free reorganizations also conflicts with current public policy. The provisions are unnecessarily complicated. The provisions use amounts to measure gain, such as the principal amount of the debt instrument, which are imprecise and do not reflect a taxpayer's actual amount of economic gain.[256] In addition, because the principal amount is used, it does not correspond to the amounts used to measure gain or loss in other contexts as well as a number of other taxable items throughout the Code, such as OID, market discount, and bond premium. These inconsistencies have been ignored despite the call of many commentators to correct them and allow taxpayers some degree of clarification and simplification in determining their tax liabilities.[257]

Additionally, the issue of the tax treatment of security instruments is further clouded because the definition of what constitutes a security instrument is unclear. Taxpayers must struggle with determining what they own before they can even move on to determining the tax consequences. By removing the distinction between a security instrument and a non-security debt instrument in the tax-free reorganization context, Congress could significantly simplify the reorganization provisions.

An exchange of security instruments should be fully taxable in the same manner as any other exchange of debt instruments in a tax-free reorganization. The distinction between the tax treatment of ownership interests in tax-free reorganizations should not be made between equity, debt, and the hybrid ownership interest of security instruments; rather, it should be simplified to distinguish solely between equity and debt. Stockholders, and holders of other equity interests, should be entitled to tax-free treatment under the reorganization provisions. As holders of equity, stockholders manifest an ownership interest and a continuing proprietary interest in the corporation. The application of the continuity of interest doctrine to security holders is misplaced. Holders of security

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256. *See* §§ 354(a)(2), 356(d)(2)(B).

257. *See* Reich, Schwartz & Rievman, *supra* note 194; Schler, *supra* note 194; *see also* Lee, *supra* note 194.

instruments should be subject to the sale or exchange rules under section 1001 in the context of a tax-free reorganization, just as all other debt instruments are subject. As debt holders, security holders cannot appropriately maintain a continuing proprietary interest in the corporation. Trying to force security holders into a category by requiring a continuing interest simply causes inconsistent and inappropriate results.

Finally, because the reorganization provisions prevent the recognition of loss, after Revenue Ruling 2004-78, many debt holders will be forced to recognize gain and will be prevented from recognizing loss in a tax-free reorganization. Revenue Ruling 2004-78 expands the definition of security instruments so significantly that it essentially changes the reorganization provisions by requiring that only one of the debt instruments in an exchange must constitute a security instrument.[258] As long as the terms of the two exchanged debt instruments match closely enough, if one of the debt instruments constitutes a security instrument, then the other debt instrument will constitute a security instrument, even if it could not have constituted a security instrument independently. This is a dangerous movement that will subject more and more debt instruments to the inequitable and inconsistent tax treatment highlighted in this Article.

258. *See* Rev. Rul. 2004-78, 2004-31 I.R.B. 108, 109.